DOCKET

SUPREME COURT
OF THE UNITED STATES

No. 12-43
Title: PPL Corporation and Subsidiaries, Petitioners
v.
Commissioner of Internal Revenue
Docketed: July 11, 2012
Linked with 11A1064
Lower Ct: United States Court of Appeals for the Third Circuit
Case Nos.: (11-1069)
Decision Date: December 22, 2011
Rehearing Denied: March 9, 2012
Questions Presented

~~Date~~~	~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~
May 9 2012	Application (11A1064) to extend the time to file a petition for a writ of certiorari from June 7, 2012 to July 9, 2012, submitted to Justice Alito.
May 10 2012	Application (11A1064) granted by Justice Alito extending the time to file until July 9, 2012.
Jul 9 2012	Petition for a writ of certiorari filed. (Response due August 10, 2012)
Jul 30 2012	Consent to filing of amicus curiae briefs, in support of either party or of neither party, received from counsel for the petitioner.
Jul 31 2012	Order extending time to file response to petition to and including September 10, 2012.
Aug 7 2012	Brief amici curiae of N. Jerrold Cohen, Carol P. Tello, and Shane A. Lord filed.
Aug 8 2012	Brief amici curiae of Rosanne Altshuler, et al. filed.
Aug 10 2012	Brief amici curiae of Southeastern Legal Foundation, et al. filed.
Sep 4 2012	Brief of respondent Commissioner of Internal Revenue filed.
Sep 19 2012	DISTRIBUTED for Conference of October 5, 2012.
Oct 3 2012	DISTRIBUTED for Conference of October 26, 2012.
Oct 29 2012	Petition GRANTED.
Dec 3 2012	Consent to the filing of amicus curiae briefs, in support of either party or of neither party, received from counsel for the petitioner.
Dec 13 2012	Joint appendix filed (2 volumes). (Statement of costs received.)
Dec 13 2012	Brief of petitioner PPL Corporation and Subsidiaries filed.
Dec 14 2012	Brief amici curiae of Patrick J. Smith, et al. filed.
Dec 18 2012	SET FOR ARGUMENT ON Wednesday, Fedruary 20, 2013
Dec 19 2012	Brief amici curiae of Entergy Corporation, et al. filed.
Dec 20 2012	Brief amicus curiae of American Electric Power Company, Inc. filed.

Dec 20 2012	Brief amici curiae of Southeastern Legal Foundation, et al. filed.
Jan 4 2013	CIRCULATED.
Jan 11 2013	Record from U.S.C.A. for 3rd Circuit is electronic.
Jan 14 2013	Brief of respondent Commissioner of Internal Revenue filed. (Distributed)
Jan 18 2013	Brief amici curiae of Anne Alstott, et al. filed. (Distributed)
Jan 24 2013	Record recieved from U.S. Tax Court. (4 boxes)
Feb 12 2013	Reply of petitioner PPL Corporation and Subsidiaries filed. (Distributed)
Feb 20 2013	Argued. For petitioner: Paul D. Clement, Washington, D. C. For respondent: Ann O'Connell, Assistant to the Solicitor General, Department of Justice, Washington, D. C.

PETITION FOR WRIT OF CERTIORARI

No. 12-43

In the
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

PETITION FOR WRIT OF CERTIORARI

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July 9, 2012

QUESTION PRESENTED

To avoid double taxation, section 901 of the Internal Revenue Code allows U.S. corporations a tax credit for income, war profits, or excess profits taxes paid to another country. This case involves application of section 901 to a "windfall tax" imposed by the United Kingdom. Although it is undisputed that the tax's practical effect is to impose a 51.75% tax on the "excess profits" certain companies earned in the four years after they were privatized, the Third Circuit—at the Commissioner's urging—deemed the tax non-creditable because the U.K. statute nominally taxes the difference between two numbers, one of which is driven exclusively by profitability during the four-year period, rather than nominally taxing the profits themselves. In a case arising out of the same U.K. tax, same tax court proceedings, and same evidentiary record, the Fifth Circuit reached the opposite conclusion and affirmed the Tax Court's considered view. Recognizing that it was creating a clear circuit split, the Fifth Circuit affirmed that courts must look beyond the form and labels of a foreign tax statute and consider the tax's practical operation and intended effect when determining whether it is creditable for U.S. tax purposes.

The question presented is:

Whether, in determining the creditability of a foreign tax, courts should employ a formalistic approach that looks solely at the form of the foreign tax statute and ignores how the tax actually operates, or should employ a substance-based approach that considers factors such as the practical operation and intended effect of the foreign tax.

RULE 29.6 STATEMENT

PPL Corporation is a publicly traded Pennsylvania corporation. No publicly held company owns 10% or more of PPL Corporation's stock.

The following subsidiaries of PPL Corporation have an interest in this litigation: (1) PPL Energy Funding Corporation, which is wholly owned by PPL Corporation; (2) PPL Global, LLC, which is wholly owned by PPL Energy Funding Corporation; (3) PMDC International Holdings, Inc., which is wholly owned by PPL Global, LLC; and (4) PPL UK Holdings, LLC, which is wholly owned by PMDC International Holdings, Inc.

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PETITION FOR CERTIORARI

To avoid the prospect of burdensome double taxation, section 901 of the Internal Revenue Code allows U.S. citizens and corporations a tax credit for any income, war profits, or excess profits tax paid to another country. For nearly 75 years, it has been settled law that whether a tax is creditable under section 901 depends on whether the tax is, *in substance*, the equivalent of a U.S. tax on net gain. It could hardly be otherwise. When assessing the U.S. tax equivalence of foreign taxes imposed under a myriad of different foreign tax regimes, there would seem to be little choice but to look beyond form to substance.

Applying that traditional approach, this should have been an easy case. It is undisputed that the tax at issue here—a windfall tax imposed by the United Kingdom—operates as a tax on the "excess profits" of certain companies that were privatized in the 1980s and 1990s. While the tax is nominally a tax on the excess "value" of those companies above their privatization price, the taxed "value" was measured entirely by the companies' profits during the four years immediately after privatization. The higher the profits, the higher the tax. And that is true not just in some vague sense of positive correlation between taxes and values and profitability. The tax indisputably operates as a 51.75% tax on excess profits during the four-year tax period.

The Commissioner nonetheless refused to treat the windfall tax as a creditable foreign tax, merely because the U.K. statute is nominally one on "value,"

not profits. The Tax Court rejected that approach as inconsistent with settled law, but the Third Circuit reversed. Shortly thereafter, recognizing that it was creating a clear circuit split, the Fifth Circuit disagreed and held the exact same windfall tax creditable, rejecting the Third Circuit's form-over-substance approach as irreconcilable with the governing regulation and case law. The Fifth Circuit and the Tax Court had it right: The hyper-formalistic approach of the Commissioner and the Third Circuit conflicts with long-standing decisions of this Court, other Courts of Appeals, and the Tax Court—not to mention with the Commissioner's own regulation and common sense. The Court should grant certiorari to resolve this square circuit conflict and reverse the Third Circuit's marked departure from the substance-based approach to creditability that the context and case law demand and that the regulation was expressly intended to incorporate.

OPINIONS BELOW

The Third Circuit's opinion is reported at 665 F.3d 60 and reproduced at App. 1. The Tax Court's opinion is reported at 135 T.C. 304 and reproduced at App. 22.

JURISDICTION

The Third Circuit rendered its decision on December 22, 2011, and denied a timely petition for rehearing on March 9, 2012. On May 10, 2012, Justice Alito extended the time for filing a petition to and including July 9, 2012. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of section 901 of the Internal Revenue Code, 26 U.S.C. § 901, and Treasury Regulation § 1.901-2 are reproduced at App. 88.

STATEMENT OF THE CASE

A. Statutory and Regulatory Background

When Congress enacted the federal income tax in 1913, it chose to tax all income earned by U.S. citizens and corporations, including income earned and taxed in foreign countries. *See* Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114. Although Congress allowed a deduction for taxes imposed by foreign countries, it did not allow a credit. As a result, the U.S. tax scheme created a significant potential for double taxation of income earned abroad. To alleviate that burden, Congress adopted the foreign tax credit, providing U.S. citizens and corporations a credit for "the amount of any income, war profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States." Revenue Act of 1918, Pub. L. No. 65-254, § 238, 40 Stat. 1057, 1080. The "primary design of the provision was to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932). Congress also intended "to facilitate the[] foreign enterprises" of domestic corporations, thereby growing the U.S. economy as a whole. *Id.* at 9.

In the century since its enactment, the foreign tax credit has become a permanent and critical

fixture of the U.S. tax system: Domestic corporations claim tens of billions of dollars in foreign tax credits each year. *See* Scott Luttrell, IRS SOI Bull., Corporate Foreign Tax Credit, 2007, p. 140 fig. B (total foreign tax credits claimed from 2003 to 2007 ranged between $50 billion and $86 billion a year).

Although Congress has amended the statute throughout the years, the provision setting forth which taxes are creditable—"income, war profits, and excess profits taxes"—has remained unchanged and is now found at section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1). Significantly, it has long been understood that the meaning of those three terms is to be derived from "our own revenue laws," not from the revenue laws of foreign countries. *Biddle v. Comm'r*, 302 U.S. 573, 579 (1938). Whether a foreign tax is an income, war profits, or excess profits tax thus depends on whether the United States considers it such, not on the labels or form chosen by the foreign country that imposes the tax. *Id.*

By Treasury regulation, a tax is an income, war profits, or excess profits tax if "[t]he predominant character of that tax is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii). To meet that standard, a tax must be "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). That is the case "if and only if the tax, judged on the basis of its predominant character, satisfies" three tests: It must be imposed (1) on realized income (*i.e.*, income that has already been earned), (2) on the basis of gross receipts (*i.e.*, revenue), and (3) on net income (*i.e.*, gross receipts

minus significant costs and expenditures). § 1.901-2(b)(1)–(4). In short, to be creditable, the foreign tax's "predominant character" must be such that it typically reaches realized gross receipts less deductible expenses—that is, net gain. Other foreign taxes, such as property taxes, are not eligible for the credit but are treated as deductible expenses.

B. The U.K. Windfall Tax

This case involves the application of section 901 to a "windfall tax" imposed by the United Kingdom in 1997. The story begins with the 1979 U.K. elections, in which the Conservative Party won control of Parliament. During the nearly two decades of Conservative Party rule that followed, the government privatized dozens of nationalized companies, including many utilities. To accomplish its privatization objectives, the government would transfer a nationalized company to a new public limited company and offer shares of the new company to the public at a fixed price per share. In U.K. parlance, that initial share offering is known as "flotation." After flotation, the company's shares would become publicly traded on the London Stock Exchange at whatever value the market set.

Although the government initially privatized primarily non-monopoly companies, it soon expanded the privatization program to include monopoly companies, which raised distinct regulatory concerns. Rather than regulate the maximum profits or rates of return of those new companies, the U.K. government decided to regulate their prices. By fixing prices for an initial period, typically four years, the government hoped to incentivize the

newly privatized companies to reduce costs and increase efficiencies, thereby maximizing profits that initially would pass exclusively to the companies and their new shareholders. Although this regulatory scheme created the potential for the companies to enjoy substantial profits during the initial term, once that term ended, the government would pass the benefits on to consumers through a downward price adjustment.

The newly privatized companies embraced this regulatory scheme whole-heartedly, and their shareholders quickly began reaping the rewards of significantly reduced costs and increased efficiencies. The public was not nearly as satisfied with its side of the bargain, however, and began demanding the very price adjustments that the government had promised to forgo until the end of each initial term. The government resisted the public pressure but ultimately paid a price: In 1997, the Labour Party defeated the Conservative Party at the polls.

The Labour Party contended that privatization had unduly benefitted many of the new companies at the expense of the public and campaigned on a promise to impose "a windfall levy on the excess profits of the privatised utilities." App. 31. The Labour Party further promised to use the revenue from that tax to fund a welfare-to-work youth employment training program. *Id.* As a Labour Party victory became increasingly likely, members of the party's shadow treasury, including the future Paymaster General and Chancellor of the Exchequer, enlisted the services of Arthur Andersen to determine how best to structure the promised tax

to raise the necessary revenue for the welfare-to-work program.

The Andersen team proposed and the incoming government agreed to a one-time "windfall tax." To calculate the "windfall" amount subject to the tax, the formula used the difference between two numbers/values: the price at which each company was sold when privatized (*i.e.*, its actual flotation value) and the notional price at which each company *should* have been sold if only the government had realized how profitable the companies would become once privatized. *See* Finance (No. 2) Act, 1997, c. 58, part I, cl. 1 & Schedule 1 (U.K.). To determine the latter retrospective number—dubbed the "value in profit-making terms"—the formula relied on a company's actual realized profits during the four-year fixed-price period immediately following privatization. In other words, the "value in profit-making terms" was (as its name suggests) based entirely on how profitable each company was during the four-year period.

As embodied in the act that Parliament passed, the windfall tax employs a simple concept and a considerably more complicated formula. The simple concept is that the new government used the companies' actual realized profits during the first four years after privatization to impose a tax reflecting the Labour Government's view that the companies had reaped windfall profits. The more profitable the company was during those four years, the higher the tax. The more complicated formula operates as follows: Total realized profits ("P") during the tax period are used to determine average annual profits, which are multiplied by a statutorily

fixed "applicable price-to-earnings ratio" of 9. Flotation value ("FV") is then subtracted, and the remainder is taxed at 23%.

Using "D" to represent how many days a company operated during the tax period, the statutory formula can be stated as follows:

$$\text{Tax} = 23\% \times [\{(365/D) \times P \times 9\} - FV]$$

Because most companies subject to the tax operated 1,461 days, or four years (with one leap day), during the relevant period, tax liability typically amounted to approximately:

$$\text{Tax} = 23\% \times [\{(9/4) \times P\} - FV]$$

Stated in those terms, the windfall tax nominally taxes the difference between two numbers or "values"—the actual flotation price and a number based on profitability during the four years after privatization. While flotation value is an actual historical number, "value in profit-making terms" does not represent any real-world value of the company based on its actual share price (such as the market value based on the publicly traded share price on a date certain). It is instead a *sui generis* number generated entirely from a company's actual profitability during the four years after privatization. Because that number is based on actual realized profits, the same formula can be restated as a tax on excess profits during the four-year period; specifically, a 51.75% tax on total period

profits in excess of 4/9 of flotation value. *See* App. 63–64.*

To illustrate, if the figures inside the brackets are multiplied by 4/9 and the figures outside the brackets are multiplied by 9/4, the formula becomes:

$$\text{Tax} = \{(9/4) \times 23\%\} \times [P - \{(4/9) \times FV\}]$$

Doing the math, that produces:

$$\text{Tax} = 51.75\% \times [P - \{(4/9) \times FV\}]$$

Thus, by restating the tax rate, the same tax can be formulated as either a 51.75% tax on profits in excess of a statutorily prescribed rate of return, or a 23% tax on the difference between two numbers ("flotation value" and "value in profit-making terms"). Under either formulation, a company's tax liability increases or decreases in direct proportion to its total profits in excess of 4/9 of flotation value for the total period. That exact mathematical correspondence demonstrates unequivocally that the windfall tax operates as a tax on profits.

C. Proceedings Below

South Western Electricity plc ("SWEB") was one of 12 regional electric companies privatized in 1990 and one of 32 companies that were more profitable than anticipated and thus became subject to the

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* The Tax Court described the tax as a 51.71% tax on profits in excess of 44.47% of flotation value. *See* App. 63. That slight variation reflects the inclusion of the extra leap year day, which makes the ratio used to determine average annual profits slightly more than 4/9. For simplicity, the Petition refers to the tax as a 51.75% tax on profits throughout.

windfall tax. SWEB's total windfall tax liability as assessed by U.K. Inland Revenue was £90,419,265 (*i.e.*, SWEB had earned about £175 million more than the Labour Government thought appropriate and was taxed for 51.75% of that amount). SWEB paid the tax in two installments, the first in 1997 and the second in 1998. At the time, SWEB was a partially owned indirect subsidiary of PPL Corporation ("PPL"). Accordingly, for its 1997 federal income taxes, PPL claimed a credit under section 901 for its share of SWEB's first payment. The Internal Revenue Service disallowed the claim, and PPL petitioned the Tax Court for review.

1. The Parties' Arguments

The essential dispute between the Commissioner and PPL boiled down to a single dispositive legal question: whether, in determining creditability, courts should use a formalistic approach that looks solely at the text of the foreign tax statute, or a substance-based approach that takes into consideration the practical and intended effect of the tax. Relying on decades of settled precedent interpreting section 901, as well as the "predominant character" standard set forth in Treasury Regulation § 1.901-2, PPL argued that creditability "depends on the substance, and not the form or label, of the tax." App. 57–58. Under that approach, the predominant character of the windfall tax is plainly "that of an income tax in the U.S. sense" because the tax by both design and effect "is likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(1)(ii), (3)(i).

In support of that conclusion, PPL provided extensive trial testimony from multiple expert witnesses, including specialists in both U.S. and U.K. tax and accounting, the sole regulator of 17 of the affected companies (including SWEB), an internationally acclaimed finance professor, and members of the Arthur Andersen team who created the windfall tax. Those experts all agreed that, in substance, the tax operates as a tax on income, and in fact operates just like past U.S. and U.K. excess profits taxes. App. 57–60. PPL's experts illustrated how the tax formula can be restated as a 51.75% tax on profits in excess of 4/9 of flotation value, a fact to which the Commissioner stipulated. App. 62. PPL's evidence also went beyond the general application of the tax to the 32 companies. To demonstrate beyond peradventure the exclusively profit-driven operation of the tax, SWEB's former treasurer explained how, once he realized the direct link between tax liability and profits, he obtained permission from Inland Revenue to restate SWEB's profits for one of the tax years and, as a result, was able to reduce SWEB's windfall tax liability in direct proportion (51.75%) to that reduction in profits. App. 61.

The Andersen witnesses also testified that the windfall tax's drafters understood that it operated as an excess profits tax, but designed it as a "value-based" tax for "presentational" reasons peculiar to the U.K. political and economic environment at the time. App. 55–56. A finance expert further explained that the term "value in profit-making terms" represents no true economic value, has no recognized meaning in any other financial context, and appears to have been coined solely to give the

tax its form. App. 60 n.17. Contemporaneous explanations also reveal the U.K. government's understanding and intent that the tax would operate as a tax on excess profits. For instance, when the Chancellor of the Exchequer announced the proposed tax, he described it as "a new and one-off windfall tax *on the excess profits* of the privatised utilities." App. 38 (emphasis added); *see also id.* (noting Inland Revenue announcement describing tax as a "windfall tax on the *excess profits* of the privatised utilities") (emphasis added). Similarly, an official U.K. Treasury publication explained the legislation as imposing a "windfall tax ... in accordance with the commitment in the Government's Election Manifesto to raise a tax on the *excess profits* of the privatised utilities." App. 39 (emphasis added).

Rather than dispute PPL's overwhelming evidence of how the windfall tax operates, the Commissioner maintained that the Tax Court could not consider the practical operation of the tax and instead was bound by its statutory formulation as a tax on the difference between two values or numbers, even though the higher of the two numbers was simply a device to determine tax liability exclusively based on profitability over a four-year period. App. 65–68. As the Commissioner put it, in an argument that would seem to deny the form-substance dichotomy altogether: "The words of the U.K. statute *are* the 'substance' of this tax." *PPL Corp. v. Comm'r*, No. 25393-07, Reply Br. for Resp. at 114. In the Commissioner's formalistic view, because the statute says it taxes "value," not realized gross receipts reduced by deductible expenses, the tax is not creditable. The Commissioner

alternatively argued that the drafters of the windfall tax intended to tax the difference between two values and used profits merely as "a reasonable approximation of how ... [c]ompanies might have been valued at the time of flotation if subsequent earnings could have been known." App. 70.

2. The Tax Court's Opinion

After reviewing hundreds of pages of expert reports and trial testimony in both this case and a parallel case involving the same question about the same U.K. windfall tax, *see Entergy Corp. v. Comm'r*, No. 25132-06 (T.C.), the Tax Court (Judge James S. Halpern) issued a 62-page opinion holding PPL's windfall tax creditable.

Like the parties, the Tax Court viewed as dispositive the legal question concerning what a court "may consider in determining whether the windfall tax is a creditable tax for purposes of section 901." App. 71. The court resolved that dispute in PPL's favor, rejecting the Commissioner's "text-bound approach ... [a]s inconsistent with the 1983 regulations' description of the predominant character standard for creditability." App. 21. Examining the regulation's instruction to consider whether "the foreign tax is likely to reach net gain *in the normal circumstances in which it applies*," § 1.901-2(a)(3)(i) (emphasis added), the court concluded that, by "implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations clearly signaled their intent that factors extrinsic to the text of the foreign tax play a role in

the determination of the tax's character." App. 72–73.

The Tax Court found that conclusion "consistent with caselaw preceding the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the 'criterion for creditability' embodied in that standard." App. 73 (citing *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982), and *Bank of America Nat'l Trust & Sav. Ass'n v. United States* ("*Bank of America I*"), 459 F.2d 513 (Ct. Cl. 1972)). It further noted that Tax Court "cases that have applied the ... regulations' predominant character standard are consistent" with that approach, and rejected the Commissioner's attempts to portray those decisions and a Second Circuit case, *Texasgulf, Inc. & Subsidiaries v. Comm'r*, 172 F.3d 209 (2d Cir. 1999), as limiting courts' review to only the form of a foreign tax statute. App. 75–76.

Reviewing the practical effect of the windfall tax on the companies that paid it, the circumstances of its adoption, and the intent and understanding of the Parliament members who adopted it, the Tax Court concluded that, "however we describe the form of the windfall tax base, our inquiry as to the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits." App. 78–79. The court explained, "[j]ust as 'a levy can in reality be directed at net gain even though it is imposed squarely on gross income,' ... so too can a foreign levy be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values." App. 81 (quoting *Bank of America I*, 459 F.2d at

519). As for PPL's restatement of the tax as a 51.75% tax on excess profits, the Tax Court concluded that the reformulation was not, as the Commissioner argued, a "hypothetical rewrite of the Windfall Tax statute," but rather "a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax." App. 83.

On the same day, the Tax Court issued a three-page memorandum opinion in the materially identical *Entergy* case relying on its *PPL* opinion to hold Entergy's windfall tax payment creditable as well. *See Entergy Corp. v. Comm'r*, 100 T.C.M. (CCH) 202 (2010).

3. The Third Circuit's Decision

The Commissioner appealed the *PPL* decision to the Third Circuit, which reversed. App. 16–19. In an opinion that lost sight of the dispositive question whether substance or form controls and became bogged down in mathematical formulas and regulatory issues not in dispute, the court concluded that the tax does not satisfy the gross receipts or realization tests set forth in § 1.901-2(b).

Although the court purported to examine the "substance" of the windfall tax, it in fact applied a wholly formalistic approach under which it refused to consider PPL's arguments about the practical or intended operation of the tax and instead resolved creditability solely based on the text of the U.K. statute. As for PPL's argument that the tax indisputably operates as a 51.75% tax on excess profits, the court inexplicably deemed that "formulation of the substance of the U.K. windfall

tax ... a bridge too far" because "[t]he regulation forbids" consideration of any formulation that "rewrite[s] the tax rate." App. 9, 14. Accordingly, the court examined whether the windfall tax satisfies the gross receipts and realization tests based on the assumption that the tax must be formulated as follows:

$$\text{Tax} = 23\% \times [2.25 \times P]$$

Of course, .23 multiplied by 2.25 is .5175, and so this formulation of the tax should have made crystal clear to the Third Circuit that the tax equaled .5175 or 51.75% of the relevant profit. Nonetheless, because it deemed such multiplication "a bridge too far," the Court concluded that "2.25 times profit" is greater than profit alone, and so concluded that the tax must not be imposed on the basis of gross receipts or realized income. App. 14–15 & n.3.

In reaching its conclusion, the court relied heavily on a single illustrative example from a section of the regulation that addresses how to determine whether a tax that is *not* based on *actual* gross receipts, but is instead based on some estimation of expected gross receipts, satisfies the gross receipts test. *See* App. 13–14; § 1.901-2(b)(3)(ii), Example 3. Although both parties explained at oral argument that that is not the situation here—the profit figure used to calculate the windfall tax is indisputably derived from *actual* gross receipts (and otherwise satisfies the regulatory tests for realized profits)—the court decided that Example 3 rendered irrelevant the mathematical certainty that a 23% tax on 2.25 times profit is identical to a 51.75% tax on profit.

PPL petitioned for panel rehearing, explaining that the court's analysis was mathematically and legally flawed. Among other things, PPL argued that the court erred by ignoring the regulation's repeated instruction to judge a foreign tax on the basis of its "predominant character" and by placing undue emphasis on a wholly irrelevant illustrative example. The panel denied the petition.

4. The Fifth Circuit's Decision

In addition to appealing the *PPL* decision to the Third Circuit, where PPL is based, the Commissioner also appealed the companion *Entergy* case to the Fifth Circuit, where Entergy is based. *See* 26 U.S.C. § 7482(b)(1)(B). After reviewing the Tax Court's analysis in *PPL* and the Third Circuit's decision rejecting it, the Fifth Circuit agreed with the Tax Court and held the windfall tax creditable. *See Entergy Corp. & Affiliated Subsidiaries v. Comm'r*, --- F.3d ---, 2012 WL 1994786 (5th Cir. 2012). Finding the Commissioner's "primacy of the ... text" argument "easy to dispatch," the court viewed the windfall tax "in practical terms" and concluded that it readily satisfies the gross receipts, realization, and net profits requirements. *Id.* at *3–*4. In doing so, the court emphasized that Parliament's decision to label an "entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax." *Id.* at *4. Although the court openly acknowledged the circuit split its decision created, it rejected the Third Circuit's reasoning as impermissibly "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Id.*

REASONS FOR GRANTING THE PETITION

The decision below squarely conflicts with the Fifth Circuit's decision rejecting the Commissioner's formalistic approach to creditability and holding the windfall tax creditable based on its practical and intended effect. Indeed, it is hard to imagine a more direct conflict: The Third and Fifth Circuits examined the very same foreign tax, the very same Tax Court opinion, and the very same arguments and evidence, with one court accepting the Commissioner's extreme form-over-substance argument and the other rejecting it. As a result, not only are two payers of the same foreign tax being subjected to different treatment under the same U.S. tax statute, but a single Tax Court opinion is now invalid for taxpayers in the Third Circuit and binding law in both the Fifth Circuit and the Tax Court, which has nationwide jurisdiction—a bizarre result that should not be allowed to stand.

Moreover, the decision below is badly flawed and allows the Commissioner to exalt form over substance in the one context where substance obviously must control—the treatment for U.S. tax purposes of a tax levied by a foreign government. As the Fifth Circuit aptly explained, the sort of hyper-formalism the Third Circuit employed is wholly at odds with past decisions of this and other courts uniformly rejecting the argument that creditability turns on the label or form of a foreign tax. In fact, because one can hardly expect foreign nations to employ the language of the Internal Revenue Code, this is a context where looking to substance is all but compelled.

Employing the well-established approach embodied in the regulation and case law, this case should have been an easy one. There is no dispute that the U.K. "windfall" statute taxes the difference between two numbers, one of which is exclusively based on "profits" as that term is used for U.S. tax purposes. The only question is whether a tax that is nominally on "value," but where "value" is calculated based solely on companies' profitability during a four-year period, operates as a tax on "profits." Unless form is all that matters, the answer is obviously yes. The varying efforts of the Third Circuit and the Commissioner to resist that conclusion are in conflict with the Fifth Circuit, the considered view of the Tax Court, and common sense. In short, the decision below is in square conflict with the decision of another circuit court, cannot be reconciled with 75 years of contrary precedent, and threatens to leave taxpayers in the Third Circuit at substantial risk of the very double taxation that Congress has sought to prevent for the past century. This Court should grant review.

I. The Decision Below Squarely Conflicts With A Fifth Circuit Decision Holding The Windfall Tax Creditable.

In a case "materially identical" to this one, the Fifth Circuit considered and rejected the Third Circuit's "form-over-substance methodology" and held the same U.K. windfall tax creditable under section 901 and § 1.901-2. *Entergy*, 2012 WL 1994786, at *1, *4. Indeed, in light of an unusual procedural posture, the conflict could hardly be more acute: The Fifth Circuit reviewed the same Tax Court opinion, the same record, and the same

arguments and expressly "disagree[d] with the Third Circuit[]," refusing to "engage in th[e] sort of formalism" that its sister circuit employed. *Id.* at *6. This Court should grant certiorari to resolve that conflict and to ensure that two federal taxpayers are not treated differently solely because they are headquartered in different states. Taxpayers in the Third Circuit should not be at greater risk of double taxation than taxpayers in the rest of the Nation.

Like PPL, Entergy claimed a substantial credit (£139,962,622) under section 901 for a U.K. windfall tax payment made by its indirect subsidiary London Electricity. The cases were assigned to the same Tax Court judge, who held bench trials in both. The court issued a detailed opinion resolving the creditability issue in PPL's case, which had a much more extensive factual record, and on the same day issued a brief memorandum opinion in *Entergy* relying on *PPL* to reach the same holding. *See supra* p. 15. Because Entergy is based in Louisiana and PPL is based in Pennsylvania, the Commissioner appealed Entergy's case to the Fifth Circuit and PPL's case to the Third Circuit, resulting in simultaneous review of the same Tax Court opinion in two different courts, one of which affirmed and one of which reversed.

According to the Third Circuit, the windfall tax is not creditable because "PPL's formulation of the substance of the U.K. windfall tax is a bridge too far." App. 9. In its view, because the text of the windfall tax statute says it imposes a 23% tax on the difference between two values, a court must turn a blind eye to the undisputed facts that one of the two "values" is driven entirely by profitability during a

four-year period and that the tax operates as a 51.75% tax on excess profits. The Third Circuit did not even mention, let alone analyze, all of the evidence confirming that the drafters of the windfall tax intended to impose an excess profits tax. Thus, while the Third Circuit paid lip service to the well-established principle that the "classification of a foreign tax hinges on its economic substance, not its form," App. 9, it nonetheless treated the form of the windfall tax as dispositive of its substance. The court did so because it interpreted § 1.901-2(b)(3)(ii) as "forbid[ding]" consideration of *any* argument that changes the statutory tax rate to demonstrate a tax's practical operation. App. 13–14. In other words, although the court recognized that the tax operates as an excess profits tax, it read the regulation to render the practical operation of the tax legally irrelevant.

The Fifth Circuit considered and correctly rejected that approach as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Entergy*, 2012 WL 1994786, at *4. Citing *Inland Steel* and *Bank of America I*, the Fifth Circuit concluded that "[t]he case law from which 26 C.F.R. § 1.901-2 is derived refutes the Commissioner's assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax's 'predominant character.'" *Id.* at *3. "Viewed in practical terms," the Fifth Circuit held, the windfall tax "clearly satisfies the realization and net income requirements," as it "is based on revenues from the ordinary operation of the utilities that accrued long before the design and implementation of the tax,"

and "*only* reached—and only *could* reach—utilities that realized a profit in the relevant period, calculating profit in the ordinary sense." *Id.*

As to the gross receipts requirement, although the Fifth Circuit recognized that "[a] tax actually directed at corporate value would not, in the ordinary sense, be imposed on the basis of gross receipts," unlike the Third Circuit, it found itself "persuaded by the Tax Court's astute observations as to the Windfall Tax's predominant character." *Id.* at *4. Specifically, it noted that "the tax's history and practical operation was to 'claw back' a substantial portion of privatized utilities' 'excess profits'"; those "profits were the difference between the utilities' income from all sources less their business expenses—in other words, ... net income"; and "[t]he tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor." *Id.* The court thus concluded: "That Parliament termed this aggregated but entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax, that is, its predominant character." *Id.* Although the Fifth Circuit acknowledged that it was parting ways with the Third Circuit, and that it is "always chary to create a circuit split," it found itself unable to "engage in this sort of formalism in light of the predominant character standard." *Id.* at *6.

The practical result of the Third and Fifth Circuits' divergent interpretations is that Entergy's windfall tax payment is creditable but PPL's is not, simply because the companies are located in two different states. Moreover, because of the manner in which the Tax Court exercises its nationwide

jurisdiction, the same Tax Court decision is now bad law for taxpayers based in the Third Circuit, but binding law for taxpayers based in the Fifth Circuit, and for taxpayers in other jurisdictions as well (including at least one with a U.K. windfall tax issue outstanding). *See Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971) (Tax Court must "follow a Court of Appeals decision which is squarely on point where appeal from our decision lies to that Court of Appeals and to that court alone" but "shall ... giv[e] effect to our own views in cases appealable to courts whose views have not yet been expressed"). Even beyond that, the Third Circuit's hyper-formalistic approach to creditability leaves taxpayers within its jurisdiction at a much more significant risk of double taxation than taxpayers in other parts of the Nation. This Court should grant certiorari to resolve this square conflict.

II. The Third Circuit Fundamentally Erred In Adopting The Extreme Formalism Urged By The Commissioner.

The decision below is deeply flawed. There is no dispute that the practical effect of the U.K. windfall tax is to tax or recapture "excess" profits earned by privatized utilities during a four-year period. Nor is there any dispute that the tax formula took profits into account and used a profits figure that satisfies every requirement of the regulatory regime. The only dispute is whether the fact that the tax was nominally one on "value" rather than "profit" is dispositive. But once it is understood that the "value" being taxed was determined exclusively based on a company's profitability during a four-year period, the extremeness of the Commissioner's formalism

becomes evident. The more profits a company made during the relevant four-year period, the more it paid in taxes. This was true not just in some vague sense that the two were positively correlated. The tax formula taxed 51.75% of excess profits during the four-year period. The one company that made no excess profits during the period paid no tax. App. 44. And when SWEB made an adjustment to its reported profits, it achieved a corresponding reduction in its "windfall tax." App. 61. That the tax was nominally on value as measured by profitability rather than on the profits themselves could only matter in a world where substance played no role in the analysis.

Indeed, if the windfall tax were really intended to capture differences in value, it would have been a simple matter to consult the public exchanges to determine a company's market-based value the next week, month, year, or four years after flotation. Instead, the U.K. government invented the concept of "value in profit-making terms," a concept that has been used in no other context, either before or after this tax. Because one of the critical numbers used to calculate the tax amount is not a real-world number that corresponds to any normal conception of valuation, the need to look at how the tax actually operates is manifest. That the Commissioner would nonetheless insist on considering only the form of the foreign tax—and not its real-world operation—is astounding.

The Tax Court, with its expertise in tax matters, saw through the Commissioner's hyper-formalistic position. As it pointed out, "[p]resumably, [the Commissioner] would agree that, had the [windfall] tax been enacted as a 'profit-based tax' instead of as

a tax on the difference between two values, it would have been creditable." App. 83 n.34. Under the Commissioner's "approach, the same tax is either creditable or noncreditable, depending on the form in which it is enacted, a result at odds with the predominant character standard set forth in the regulations and applied in the caselaw." App. 83 n.34. As the Tax Court explained at length, the whole point of § 1.901-2 and its predominant character standard was to adopt the approach of a string of decisions—decisions that begin with this Court's early examination of the foreign tax credit statute—rejecting the very form-over-substance approach the Commissioner now advocates. *See* App. 47–57.

As far back as 1938, this Court had no trouble rejecting the illogical argument that the creditability of a foreign tax should "depend upon its characterization by the foreign statutes and by decisions under them." *Biddle*, 302 U.S. at 578. As the Court explained, tax terminology "has for most practical purposes a well-understood meaning to be derived from an examination of the [U.S.] statutes which provide for the laying and collection of income taxes," and "[i]t is *that* meaning which must be attributed" to the terms used in the foreign tax credit statute. *Id.* at 579 (emphasis added). As a matter of common sense, any other approach would produce "a shifting standard" for creditability based on the vagaries of "foreign characterizations and classifications of tax legislation" by countries that may not use the same language, let alone the same tax system, as the United States. *Id.* Nothing in the foreign tax credit statute suggests Congress

intended such a counterintuitive result. *See id.* at 578–79.

Following *Biddle*'s instruction to "examin[e] ... the *manner* in which the [foreign] tax is laid and collected," *id.* at 579 (emphasis added), lower courts have repeatedly determined creditability by focusing on the substance, not the form, of foreign taxes. For instance, in the early 1970s, the Court of Claims confirmed in *Bank of America I* that the "important thing" is the substance, not the form, of a foreign tax. 459 F.2d at 519. That case involved three foreign taxes that were designated "income taxes" in their respective countries but did not appear to satisfy "the United States notion of income taxes" because they were imposed on gross receipts, with no deduction for costs or expenses. *Id.* at 517. In keeping with *Biddle*, the Court of Claims refused to "consider it alldecisive [*sic*] whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing profit." *Id.* at 519. The court instead considered "whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." *Id.*

Two years later, the Tax Court employed the same substance-over-form approach, citing *Bank of America I* for the proposition that "the 'basic' test for determining whether a foreign tax is creditable is whether it is the substantial equivalent of an 'income tax' as revealed by an examination of our statutes." *Bank of America Nat'l Trust & Sav. Ass'n v. Comm'r* ("*Bank of America II*"), 61 T.C. 752, 760 (1974). Examining the text, statutory history, and

purpose of the foreign tax credit statute, the Tax Court concluded that the Court of Claims' substance-based approach "provides a rational and manageable basis for interpretation of section 901(b)(1), consistent with the statutory language and purpose and with the previously decided cases." *Id.* at 763. Since then, in *Inland Steel*, the Court of Claims reiterated that "[t]he label and form of the foreign tax is not determinative," and reviewed the legislative history and practical effect of a tax to determine creditability. 677 F.2d at 80.

Shortly after *Inland Steel*, the Treasury Department promulgated § 1.901-2, which defines an "income tax" in the same manner as those cases: A tax is an "income tax" if "[t]he predominant character of that tax is that of an income tax in the U.S. sense," which is the case if the tax is "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(1)(ii), (3)(i); *compare Bank of America I*, 459 F.2d at 519–20 (tax is an income tax if "it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies"). As the preamble to the regulation explains, "[t]his standard ... adopts the criterion for creditability set forth in *Inland Steel* ..., *Bank of America* [*I*] ..., and *Bank of America* [*II*]." 48 Fed. Reg. 46,272, 46,273 (Oct. 12, 1983).

Notwithstanding that clear instruction to read § 1.901-2 in harmony with the substance-over-form approach of the cases that came before it, and brushing aside the Tax Court's analysis of how the U.K. windfall tax clearly operated as a tax on excess profits, the Third Circuit inexplicably concluded that

the Commissioner's hyper-formalistic approach was somehow compelled by a regulation expressly intended to reject it. As the Fifth Circuit correctly recognized, nothing in the regulation supports the Third Circuit's dubious conclusion that § 1.901-2 is "in tension with" the very cases it "purports to adopt." App. 6–7 n.1.

At the outset, there is no merit to the Third Circuit's suggestion that other courts have perceived such non-existent "tension" between § 1.901-2 and the wealth of section 901 cases. *See* App. 6–7 n.1. In fact, after considering the issue in depth, the Second Circuit concluded that, if anything, the regulation compels a *more* flexible approach to creditability. *See Texasgulf*, 172 F.3d at 216–17. *Texasgulf* involved the same tax the Court of Claims had deemed not creditable in *Inland Steel*. Relying on a provision that instructs courts to consider whether a foreign tax on an amount in excess of net profit nonetheless "provides allowances that effectively compensate for nonrecovery of ... significant costs or expenses," § 1.901-2(b)(4)(B), the court found itself bound by the regulation to place even greater weight on the tax's substance than the *Inland Steel* decision had, and thus rejected the Court of Claims' pre-regulation conclusion that the same tax was not creditable. *See* 172 F.3d at 216–17. In doing so, the Second Circuit interpreted § 1.901-2 as encouraging examination of the same type of "empirical evidence" of a tax's practical effect the Third Circuit rejected here. *Id.* at 215.

The Tax Court reached the same conclusion in *Phillips Petroleum Co. v. Commissioner of Internal Revenue*, 104 T.C. 256 (1995), a case involving the

application of materially analogous provisions of an interim version of the regulation to three Norwegian taxes. To determine whether two of the taxes were royalties, the court undertook an "exhaustive examination of the [taxes themselves], other Norwegian general tax legislation, legislative history, [and] the testimony from two Norwegian tax experts." *Id.* at 288. And to determine whether the third was "most appropriately described as an 'excess profits' tax, as Congress has used that term when it has been written into the Internal Revenue Code," the court studied the "purpose, design, and effect" of the tax on the companies that paid it. *Id.* at 291, 316. As *Phillips Petroleum* and *Texasgulf* reflect, there is simply no merit to the Third Circuit's suggestion that § 1.901-2 was intended to do anything other than what its preamble says—adopt the substance-based approach to creditability that every decision before it had employed.

The Third Circuit derived its contrary conclusion primarily from Example 3 of the gross receipts subsection of the regulation, which it seemed to think superimposed extreme formalism not just on the gross receipts analysis, but on the entirety of § 1.901-2. But as the Fifth Circuit explained, Example 3 "do[es] not illustrate the meaning of '*actual* gross receipts'" at all—it instead deals with the discrete concept of "*imputed* gross receipts," a concept with no application whatsoever here. *Entergy*, 2012 WL 1994786, at *5 (emphasis added). While certain methods of imputing gross receipts may be appropriate when actual gross receipts are "difficult to calculate or impractical to know," some foreign countries have also "use[d]

imputed, rather than actual, income formulas ... 'structured to tax artificial or fictitious income' in order to increase domestic tax receipts." *Id.* Example 3 is thus part of a series of examples designed to "differentiate between permissible *imputed* actual gross receipts and impermissible notional amounts," *id.*, not to superimpose rigid formalism on the entire creditability inquiry.

Unlike in those examples, the U.K. windfall tax "at no point imputes gross receipts," as "gross receipts were actually known" long before the windfall tax "was even proposed." *Id.* Indeed, the nominal "value" taxed by the windfall tax can be calculated only once historical profits in the four years after privatization are known. Accordingly, "an example detailing an impermissible method for calculating *imputed* gross receipts (based on historical practices by OPEC countries) is facially irrelevant" to the creditability of the windfall tax. *Id.* Indeed, there is no question that "a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts" as that term is understood in U.S. tax law. *Id.* at *6. Only by accepting the Commissioner's anomalous invitation to turn a blind eye to the practical operation of the windfall tax could the Third Circuit nonetheless hold the tax not creditable, albeit by focusing on an inapposite example that even the Commissioner recognizes is irrelevant. That it erroneously employed such a hyper-technical approach in the context of a foreign country whose tax laws are among the most comparable to our own leaves little doubt that the Third Circuit—and the Commissioner—would not hesitate to do the same

when dealing with taxes from the many countries whose provisions are even less likely to have the attributes of U.S. taxes on their face.

In short, the extreme formalism adopted by the Third Circuit at the Commissioner's urging cannot be reconciled with the text of section 901, decades of precedent uniformly employing a substance-over-form approach to creditability, the Commissioner's own regulation doing the same, or common sense. It is one thing to insist that players within the U.S. governmental and legal systems turn square corners, but it makes no sense to refuse to look beyond form when evaluating the U.S. tax consequences of taxes imposed by foreign governments. This Court should grant certiorari to reject the Commissioner's profoundly misguided approach and rectify the Third Circuit's erroneous departure from settled precedent "eschew[ing]" the "form-over-substance methodology" that its decision "exemplifies." *Id.* at *4.

III. The Third Circuit's And The Commissioner's Elevation Of Form Over Substance Has Broad Implications For Taxpayers.

At a very basic level, the formalistic approach to creditability urged by the Commissioner and adopted by the Third Circuit is at odds with one of the most fundamental tenets of tax law. The principle that substance trumps form is not unique to the foreign tax credit statute. It is the "cornerstone of sound taxation," and its "most persistent advocate ... is ... the Commissioner." *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961); *see also, e.g.*, *Boulware v. United States*, 552 U.S. 421 (2008); *Higgins v. Smith*, 308 U.S. 473 (1940); *Gregory v.*

Helvering, 293 U.S. 465 (1935); *see generally* Joseph Isenbergh, *Review: Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859 (1982).

If anything, that foundational principle should apply with all the more force in this context, where the task is to consider the U.S. tax consequences of statutes that may be written in foreign languages and based on foreign tax codes. This Court has been wary of creating "magic word" tests even when dealing with the U.S. Congress. *See, e.g.*, *Henderson ex rel. Henderson v. Shinseki*, 131 S. Ct. 1197, 1203 (2011); *Morrison v. National Austl. Bank Ltd.*, 130 S. Ct. 2869, 2883 (2010). But it is hard to imagine a context less well suited to extreme formalism than the consideration of the U.S. tax consequences of taxes imposed by foreign nations. Those taxes can be assessed in a wide range of manners, by countries with radically different tax systems, in a myriad of different languages, and for political, economic, and social reasons unique to those countries. The process of translating—literally and figuratively—those foreign taxes for purposes of U.S. taxes demands an inquiry into substance. Yet neither the Third Circuit nor the Commissioner even attempted to provide any justification for abandoning substance in a setting where doing so seems to serve no purpose other than filling the government's coffers. In this context no less than in any other, "[r]esort to substance" should not be "a right reserved for the Commissioner's exclusive benefit, to use or not to use—depending on the amount of the tax to be realized." *Estate of Weinert*, 294 F.2d at 755; *see also Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985) (same).

The potential consequences of the Commissioner's anomalous elevation of form over substance reach well beyond the specific factual context of this case. Domestic corporations claim tens of billions of dollars in foreign tax credits each year. *See supra* p. 4. Because § 1.901-2's "predominant character" standard and the three-factor test apply to income, war profits, and excess profits taxes alike, *see* § 1.901-2(a)(1), the Third Circuit's misguided approach threatens the creditability of every foreign tax that does not precisely mirror a U.S. income tax. Perhaps even more troublingly, the Commissioner's willingness to urge such extreme formalism in the context of a tax that is so obviously creditable when viewed in practical terms leaves little doubt that the Commissioner would not hesitate to do the same in a context where the practical operation of a foreign tax is not so readily identifiable. Thus, as a prominent tax publication has noted, "the *PPL* and *Entergy* decisions represent more than just disparate views of a narrow tax question"; they "raise[] fundamental questions about the test for creditability." 136 Tax Notes 139, 141 (July 9, 2012).

In addition, the Third Circuit made the profoundly troubling suggestion that, in direct contradiction to the statute's text, an excess profits tax could *never* be creditable under the regulation's three-factor test. *See* App. 10–11 n.2. The court appeared to believe that because § 1.901-2 does not explain how to distinguish excess profits from net profits, it does not contemplate that excess profits taxes are creditable at all, simply because *excess* profits will always be less than *net* profits. *See* App.

10–11 n.2 (suggesting PPL should have "argued that the ... regulation was arbitrary or capricious because it mingles 'excess profits taxes' with the other statutory terms"). That alone reveals how deeply confused and lost the court was—nothing in § 1.901-2 remotely suggests that a tax on a *subset* of net gain somehow ceases to satisfy the net gain test. Quite the contrary, as the cases from which § 1.901-2 is derived make clear, the point of the test is to ensure that "the other country is attempting to reach *some* net gain," not *all* net gain. *Bank of America I*, 459 F.2d at 519 (emphasis added). The Third Circuit's erroneous suggestion otherwise injects substantial uncertainty into the creditability analysis for all excess profits taxes.

Finally, wholly apart from the broader consequences of the Commissioner's newfound aversion to the substance-over-form principle that he is typically the first to embrace, the creditability of the windfall tax is itself an issue of significant consequence. PPL sought a combined credit of $27.3 million for SWEB's windfall tax payments; with interest, the financial impact of the creditability issue for PPL is approximately $39 million. Entergy claimed a $234 million credit for London Electricity's windfall tax payments, *see Entergy*, 2012 WL 1994786, at *1, and American Electric Power Company, Inc., is currently engaged in administrative proceedings on the same issue in relation to approximately $285 million in windfall taxes paid by two of its subsidiaries. Thus, those three companies alone have hundreds of millions of dollars riding on whether the windfall tax is creditable and, at the moment, they are being

treated differently for no reason other than where they happen to be headquartered.

In short, the decision below creates a direct, acknowledged, and untenable circuit split, adopts a deeply flawed approach to creditability that is irreconcilable with the governing regulation and case law, and casts a long and lingering shadow over the creditability of foreign taxes paid by U.S. taxpayers. The Tax Court and the Fifth Circuit correctly recognized that the Commissioner's hyper-formalistic arguments have no place in the foreign tax credit context, which by its very nature demands a practical and substance-based approach to creditability. This Court should grant review and do the same.

CONCLUSION

The Court should grant the petition.

Respectfully submitted,

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July 9, 2012

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Appendix A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11-1069

PPL CORPORATION AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

Appeal from the Decision of the
United States Tax Court
Docket No. 07-25393
Tax Court Judge: Honorable James S. Halpern

Argued September 22, 2011

Before: AMBRO, CHAGARES and *GARTH,
Circuit Judges

PRECEDENTIAL
(Opinion filed: December 22, 2011)

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* Participated in Video Conference

OPINION OF THE COURT

AMBRO, Circuit Judge

The Commissioner of Internal Revenue appeals a decision of the United States Tax Court holding that PPL Corporation was entitled to a foreign tax credit for the 1997 tax year under § 901 of the Internal Revenue Code. We agree with the Commissioner that the foreign tax before us does not qualify for a foreign tax credit, and thus reverse.

I. Background

PPL is a Pennsylvania corporation. In 1997, it held a 25% stake in SWEB (formerly South Western Electricity Board), a utility in the United Kingdom. SWEB was one of 32 United Kingdom companies subject to a one-time "windfall tax." After it paid that tax, PPL claimed under I.R.C. § 901 a foreign tax credit on its United States tax return. We must decide whether the U.K. windfall tax is an "income, war profits, [or] excess profits" tax within the meaning of § 901(b)(1).

The windfall tax emerged from a backlash against the privatization of British utilities and transit operators. The U.K.'s Government, then controlled by the Conservative Party, sold SWEB and 31 other state-owned companies to private investors between 1984 and 1996. Though privately owned, the utilities remained regulated. In particular, the U.K. Government set the rates at which the utilities would sell electricity to customers. With the pricing scheme, it induced the new private owners to provide electricity more efficiently; every pound sterling that the owners

could save would go to them as profit rather than to customers as lower prices. Most of the utilities, including SWEB, increased efficiency to a greater degree than the U.K. Government had expected. As a result, the utilities' profits and their share prices increased. Executive compensation also increased, as it was tied in many cases to share prices. These high profits and compensation packages, coupled with the fixed costs that customers paid under the regulatory scheme, left the public unhappy with the utilities and their executives.

The opposition Labour Party sought to capitalize on this public discontent by introducing a new tax. Party leaders promised a "windfall levy on the excess profits of the privatised utilities," in the words of Labour's 1997 Election Manifesto. They put Geoffrey Robinson, a Labour Member of Parliament, in charge of the plan. He hired accounting firm Arthur Andersen to develop a series of proposals. Robinson and the Andersen team rejected simpler proposals, including taxes on gross receipts or on profits, and instead selected the "windfall tax" now at issue. Gordon Brown, then the Shadow Chancellor of the Exchequer, approved Robinson's windfall tax proposal, and Parliament enacted it without substantive change after Labour won the 1997 elections.

In concept, the windfall tax was a one-time 23% tax on the difference between each company's "profit-making value" and its "flotation value," the price for which the U.K. Government had sold it. (The public believed that the Government had sold the companies too cheaply, hence the "windfall.") The tax statute defined each company's "profit-making

value" as its average annual profit multiplied by its price-to-earnings ratio. It defined average annual profit as the company's average profit per day over a statutorily defined "initial period" (which for SWEB and most others was the first four years after privatization) multiplied by 365. Rather than using the companies' actual price-to-earnings ratios, the statute imputed a ratio of 9 for all companies. This "ratio," a U.K. Government document explained, "approximates to the lowest average sectoral price-to-earnings ratio of the companies liable to the tax." J.A. at 264. We may express the tax algebraically in this way:

$$\text{Tax} = 23\% \times [(365 \times (P / D) \times 9) - FV],$$

where 23% is the tax rate, P is the company's total profit over the "initial period," D is the length of the initial period in days, and FV is the company's flotation value (to repeat, the price for which the U.K. Government sold the company).

SWEB paid the windfall tax, and PPL filed with the IRS a claim for refund seeking a foreign tax credit for PPL's share of the windfall tax paid. In 2007, the IRS denied PPL's claim for refund and issued a notice of deficiency. PPL then filed a petition in the Tax Court to challenge the IRS's determination that it was not entitled to a credit under I.R.C. § 901 for PPL's share of SWEB's windfall tax. The Tax Court held a trial and, after post-trial briefing and further testimony, agreed with PPL that it was entitled to a foreign tax credit. The Commissioner timely appealed to our Court, asserting that § 901 does not cover the windfall tax.

The Tax Court had jurisdiction under I.R.C. §§ 6213 and 6214, and our Court has jurisdiction under I.R.C. § 7482(a)(1). "We have plenary review over the Tax Court's legal conclusions, and may set aside findings of fact if they are clearly erroneous." *Capital Blue Cross v. Comm'r*, 431 F.3d 117, 123-24 (3d Cir. 2005).

II. Discussion

A. The Applicable Test

To determine whether the U.K. windfall tax is a creditable foreign tax, we start with I.R.C. § 901(b)(1). That subsection provides a tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." Congress first enacted these words in 1918, and it has not changed them since. *See Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256, 284 (1995) (discussing legislative history). In the decades that followed, "the word 'income' in section 901(b)(1) [became] the subject of a long and tortuous history" in case law that was "permeated" with "vagaries, confusion, and seeming contradictions." *Bank of Am. Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. 752, 759 (1974).

The Treasury Department explained and clarified § 901(b)(1) in a 1983 regulation, Treasury Regulation 1.901-2, which the parties agree governs our case. We follow our sister Courts of Appeals in according it the force of law. *See, e.g., Texasgulf, Inc. v. Comm'r*, 172 F.3d 209 (2d Cir. 1999); *Amoco Corp. v. Comm'r*, 138 F.3d 1139 (7th Cir. 1998).

The regulation's purpose is to define "income, war profits, [or] excess profits tax" within the meaning of I.R.C. § 901(b)(1). The regulation combines those statutory terms into the single concept of an "income tax." Treas. Reg. § 1.901-2(a)(1). It provides that a foreign assessment is an "income tax" if it has the "predominant character . . . of an income tax in the U.S. sense." *Id.* § 1.901-2(a)(1)(ii). (It also requires that the foreign tax be a "tax," which is not at issue here.) The regulation then provides that a foreign assessment has a tax "character" if it is "likely to reach net gain in the normal circumstances in which it applies." *Id.* § 1.901-2(a)(3)(i). And it is "likely to reach net gain . . . *if and only if* the tax, judged on the basis of its predominant character,"[1] satisfies *each* of three

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[1] Because the regulation repeats the phrase "predominant character" throughout its definitions, both the Tax Court and PPL on appeal suggest that it applies a "predominant character standard" independent of the three requirements. That is incorrect. We must assess whether a foreign tax satisfies each of the regulation's three requirements "judged on the basis of its predominant character." Treas. Reg. § 1.901-2(b)(1), (b)(2), (b)(3), (b)(4). We may not, however, simply ask whether the "predominant character" of a foreign tax is that of a U.S. income tax without addressing the requirements. The Court of Claims did essentially that in a pair of cases that predated the Treasury regulation governing our case. *See Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) (*per curiam*); *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972).

A single paragraph in the Treasury regulation's preamble purports to adopt both the Court of Claims' approach and the three-requirement test. Creditability of Foreign Taxes, 48 Fed. Reg. 46,272, 46,273 (Oct. 12, 1983). Those two approaches to

requirements: the "realization" requirement, the "gross receipts" requirement, and the "net income" requirement. *Id.* § 1.901-2(b)(1) (emphases added).

The realization requirement is that the tax is imposed on or after the occurrence of events that would result in the realization of income under U.S. tax law. *Id.* § 1.901-2(b)(2). The gross receipts requirement is that the tax is imposed on gross receipts or an amount not greater than gross receipts. *Id.* § 1.901-2(b)(3). The net income requirement is that computing the tax demands deducting from gross receipts the costs and expenses incurred in earning those receipts. *Id.* § 1.901-2(b)(4). We determine whether each requirement is met "judged on the basis of [the] predominant character" of the tax. *Id.* § 1.901-2(b)(2), (b)(3), (b)(4). We do so mindful that "[b]ecause § 901's exemption from taxation is 'a privilege extended by legislative grace,' it is strictly construed." *Texasgulf*, 172 F.3d at 214 (quoting *Inland Steel Co. v. United States*, 677 F.2d 72, 79 (Ct. Cl. 1982) (*per curiam*)).

The three requirements concern the *timing* and the *base* of the foreign tax. The realization requirement, one of timing, ensures that the

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§ 901 are, at the least, in tension with one another. We resolve this tension in favor of the text of the regulation, which does not include the preamble. In doing so, we follow the Second Circuit's decision in *Texasgulf*, which considered the same foreign tax that the Court of Claims had in *Inland Steel* but reached the opposite result, the former deciding that the Ontario Mining Tax was creditable under § 901, *Texasgulf*, 172 F.3d at 216-17, and the latter ruling that it was not, *Inland Steel*, 677 F.2d at 87.

taxpayer has received income before being obligated to pay taxes on it. *See Helvering v. Horst*, 311 U.S. 112, 115 (1940) ("'[R]ealization' is not deemed to occur until the income is paid."). The main effect of this requirement is to exclude from "income" the appreciation in value of property that its owner has not yet sold. The gross receipts and net income requirements present questions about the tax base, the amount on which the tax is levied. The amount that a particular corporation owes is the product of its tax base multiplied by its tax rate.

B. The Tax Base

The parties offer dueling perspectives on the base of the windfall tax. In the Commissioner's view, the tax base is what the U.K. statute says it is: the difference between two imputed values of each affected company. The first value is the company's "profit-making value," defined as its average annual profit during its "initial period" (that is, average profit per day over the initial period, multiplied by 365) times 9, the assumed price-to-earnings ratio. The second value is the company's "flotation value," the amount for which the U.K. Government sold the company to investors. Neither value represents the company's gross receipts, nor does the tax base account for recognizable costs and expenses such as employee costs. Thus, the Commissioner contends, the "windfall tax" fails to meet either the gross receipts or the net income requirement under the U.S. regulation.

In PPL's view, looking through the form of the tax to its substance reveals that "the [t]ax [i]s, in substance, a tax on profits, specifically on excess

profits." PPL Br. at 43 (citation and internal quotation marks omitted). Our classification of a foreign tax hinges on its economic substance, not its form. *See Boulware v. United States*, 552 U.S. 421, 429 (2008) ("[T]ax classifications . . . turn on 'the objective economic realities of a transaction rather than . . . the particular form the parties employed'; a 'given result at the end of a straight path is not made a different result . . . by following a devious path.'") (citations omitted). PPL's expert testimony purports to establish that initial-period profit would satisfy the gross receipts and net income requirements.

In our view, PPL's formulation of the substance of the U.K. windfall tax is a bridge too far. No matter how many of PPL's proposed simplifications we may accept, we return to a fundamental problem: the tax base cannot be initial-period profit alone unless we rewrite the tax rate. Under the Treasury Department's regulation, we cannot do that.

PPL's proposal and its fatal flaw are best understood in algebraic terms. Once again, the U.K. statute computes each company's tax thus:

$$\text{Tax} = 23\% \times [(365 \times (P / D) \times 9) - FV],$$

where 23% is the tax rate, P is the company's initial-period profit, D is the length of the initial period in days, and FV is the company's flotation value. Were this a tax on initial-period profit, as PPL contends that it is in substance, the tax base would be simply P, so that we could express the tax thus:

$$\text{Tax} = 23\% \times P.$$

No amount of emphasis on substance over form can take us from the first equation to the second.

If profit is in essence the only variable in the tax base, we would first need to explain away the other two variables that the U.K. statute puts there. For the sake of argument, we do so as PPL suggests. First, we assume that the "initial period" for all companies is 1,461 days long—in other words, that *D* equals 1,461. Twenty-nine of the 32 affected companies had initial periods of 1,461 days—four years (4 x 365) plus one day for leap year—or just shy of it. Second, we assume that each company's flotation value (the variable *FV*) is not relevant for the purpose of satisfying the regulation's three requirements. PPL contends that we should do so because the flotation value in the U.K. windfall tax merely gives that tax the form of historical "excess profits" taxes.[2]

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[2] Section 901(b)(1) establishes a credit for "any income, war profits, and excess profits taxes" paid to a foreign nation. As we noted above, the relevant Treasury regulation treats those three taxes as though they are identical. Treas. Reg. § 1.901-2(a)(1). PPL protests that the regulation "does not address the elements necessary to [distinguish] 'excess profits' from 'normal profits.' . . . One must search [beyond the regulation] to determine the predominant character of an excess profits tax." PPL Br. at 36. In other words, PPL submits, the regulation cannot tell us what an "excess profits" tax is because it does not define that term specifically. Instead, we are invited to look to World War I-era "excess profits" taxes, which, we are told, would render flotation value irrelevant to our analysis.

But this argument merely suggests that the regulation misinterprets the statute. The regulation expressly defines an excess profits tax as an "income tax," which for the purposes of

These two modifications would make the tax base appear to be quite different. Rather than the statutory formula, that is,

$$\text{Tax} = 23\% \times [(365 \times (P / D) \times 9) - FV],$$

we would confront this new formula:

$$\text{Tax} = 23\% \times [(365 \times (P / 1{,}461)) \times 9],$$

because we have substituted 1,461 for D and eliminated FV. And because P is the only variable left, we may combine the remaining numbers in the tax base. Multiplying 365 by 9, then dividing by 1,461, equals roughly 2.25. Thus, we could express the U.K. windfall tax even more simply:

$$\text{Tax} = 23\% \times [2.25 \times P].$$

PPL's two proposed simplifications boil down to this formula.

Even accepting those simplifications, this tax base would violate the gross receipts requirement under the following logic:

- The tax base that PPL's two simplifications produce is 2.25 times profit;

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the regulation is a tax that satisfies the realization, gross receipts, and net income requirements. PPL could have argued that the Treasury Department's regulation was arbitrary or capricious because it mingles "excess profits taxes" with the other statutory terms. But it did not. Instead, PPL agrees with the Commissioner that Treasury Regulation 1.901-2 governs this case. *See id.* at 30-33, 35, 52. We nonetheless indulge for the sake of argument PPL's contention that historical practice allows us to cast flotation value aside. Doing so does not affect our holding.

- Profit equals gross receipts minus expenses;
- Thus the tax base that PPL's two simplifications produce is 2.25 times gross receipts minus 2.25 times expenses;
- The gross receipts requirement addresses the income portion of a tax base, whereas the net income requirement addresses the expense portion of a tax base; and
- Hence the income portion of this tax base—2.25 times gross receipts—violates the gross receipts requirement, which limits the basis of a tax to gross receipts or an approximation thereof "likely to produce an amount that is *not greater than* [their] fair market value." Treas. Reg. § 1.901-2(b)(3)(B) (emphasis added).

PPL attempts to skirt this logic by changing the tax rate. A 23% tax on 2.25 times profit, PPL observes, is mathematically identical to a 51.75% tax on profit, because 23% times 2.25 equals 51.75%. PPL Br. at 25-26. In other words, returning to our formula, PPL would make one last modification:

$$\text{Tax} = 23\% \times [2.25 \times P] = 51.75\% \times P.$$

Rewritten in this way, the tax base is profit alone. This tax base, PPL posits, would not offend the gross receipts requirement because the starting point for calculating profit is gross receipts.

However, changing the tax rate in this way to avoid a problem with the tax base would read the gross receipts requirement out of the regulation. This we decline to do. An example from the Treasury

regulation illustrates why our law does not tolerate such a mathematical maneuver. In the example, another country imposes a tax on the extraction of petroleum. Treas. Reg. § 1.901-2(b)(3)(ii), Ex. 3. The country deems "gross receipts" to equal 105% of the market value of the petroleum extracted. That is, the starting point for the tax base is 105% of each affected company's gross receipts from petroleum. The regulation disallows a credit for the tax because it "is designed to produce an amount that is greater than the fair market value of actual gross receipts." *Id.* As the tax would not even be creditable up to the amount imposed on 100% of gross receipts, less associated costs, the entirety of the tax fails to satisfy the requirement. This all-or-nothing result is so because the regulation mandates that "a tax either is or is not an income tax, *in its entirety*, for all persons subject to the tax." *Id.* § 1.901-2(a)(1)(ii) (emphasis added). If 105% of gross receipts (barely more than actual receipts) does not satisfy the requirement, then 225% is in the same boat but another ocean.

In this example, as with the U.K. windfall tax, manipulating the tax rate could in theory fix the problem. Say that the tax rate on the hypothetical extraction tax is 20%. It is true that a 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts, the latter of which would satisfy the gross receipts requirement. PPL proposes that we make the same move here, increasing the tax rate from 23% to 51.75% so that there is no multiple of receipts in the tax base. But if the regulation allowed us to do that, the example would be a nullity. *Any* tax on a multiple of receipts

or profits could satisfy the gross receipts requirement, because we could reduce the starting point of its tax base to 100% of gross receipts by imagining a higher tax rate. The regulation forbids that outcome.[3]

III. Conclusion

Even if we accept PPL's contention that the U.K. windfall tax is in substance a 23% tax on 2.25 times profits, that tax fails to satisfy at least the gross

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[3] To repeat, a tax must satisfy the regulation's three requirements to be creditable. A tax's failure to satisfy any one of the three tests renders it not creditable, regardless whether it satisfies the other two tests. Because the U.K. tax fails to satisfy the gross receipts requirement, it is not creditable. Nonetheless, we also believe that (laying aside any discussion of the net income requirement) the tax fails to satisfy the realization requirement. To meet that test, the tax must be imposed "[u]pon or subsequent to the occurrence of events ('realization events') that would result in the realization of income . . . ." Treas. Reg. § 1.901-2(b)(2)(i)(A). The "income" that PPL asserts is at issue here is initial-period profit. But as we have explained, the amount being taxed (the "income") was greater than initial-period profit. The U.K. windfall tax did not ensure that the companies had actually realized the amount being taxed. In SWEB's case, for example, initial-period profit was £306.2 million, but the taxable amount was approximately £393.1 million after subtracting flotation value. SWEB did not realize the full latter amount as profit over its initial period. *See Eisner v. Macomber*, 252 U.S. 189, 211 (1920) (holding that income is not realized unless it "is available for actual distribution"). Putting aside the Commissioner's other arguments, this alone belies PPL's claim that the windfall tax meets the realization requirement, as the tax was not imposed on past profit (and certainly not on excess profit, which of course is less than total profit).

receipts requirement. Without changing the tax rate, the calculation of the tax base begins with an amount greater than gross receipts. And we may not manipulate the tax rate to address a question about the tax base.

Thus, we hold that the windfall tax is not creditable and reverse the decision of the Tax Court.

Appendix B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11-1069

PPL CORPORATION AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

Appeal from the Decision of the
United States Tax Court
Docket No. 07-25393
Tax Court Judge: Honorable James S. Halpern

Argued September 22, 2011

Before: AMBRO, CHAGARES and GARTH, Circuit Judges

AMENDED JUDGMENT

This cause came to be heard on the record before the United States Tax Court and was argued on September 22, 2011.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the decision of the Tax Court dated October 14, 2010, is hereby

reversed to the extent that the decision reflected the Tax Court's opinion that the U.K. windfall tax is a creditable foreign tax and we remand the case to the Tax Court to consider the dividend rescission issue. Costs taxed against Appellee. All of the above in accordance with the opinion of this Court.

ATTEST:

/s/Marcia M. Waldron
Clerk

Dated: January 13, 2012

Appendix C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11-1069

PPL CORPORATION AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

(Tax Court No. 07-25393)

January 12, 2012

Present: AMBRO, CHAGARES and GARTH, Circuit Judges

Unopposed Motion by Appellee to Clarify Judgment

Respectfully,
Clerk/dwb

ORDER

The foregoing motion is granted. An amended judgment shall be issued. The language of the amended judgment shall be as follows:

This cause came to be heard on the record before the United States Tax Court and was argued on September 22, 2011.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the decision of the Tax Court dated October 14, 2010, is hereby reversed to the extent that the decision reflected the Tax Court's opinion that the U.K. windfall tax is a creditable foreign tax and we remand the case to the Tax Court to consider the dividend rescission issue. Costs taxed against Appellee. All of the above in accordance with the opinion of this Court.

The time for filing a petition for rehearing shall run from the date of the amended judgment.

By the Court,

/s/ Thomas L. Ambro, Circuit Judge

Dated: January 13, 2012

Appendix D

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11-1069

PPL CORPORATION AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

Appeal from the Decision of the
United States Tax Court
Docket No. 07-25393
Tax Court Judge: Honorable James S. Halpern

Before: AMBRO, CHAGARES and GARTH, Circuit Judges

PETITION FOR PANEL REHEARING

The petition for panel rehearing filed by Appellant in the above entitled case having been submitted to the judges who participated in the decision of this Court and no judge who concurred in the decision having asked for rehearing, the petition for rehearing is DENIED.

By the Court,

/s/ Thomas L. Ambro, Circuit Judge

Dated: March 9, 2012

Appendix E

UNITED STATES TAX COURT

No. 25393-07

PPL CORPORATION AND SUBSIDIARIES,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Filed September 9, 2010
135 T.C. No. 15

Held: The United Kingdom windfall tax enacted on July 2, 1997, and imposed on certain British utilities is a creditable tax under sec. 901, I.R.C.

HALPERN, Judge: PPL Corp. (petitioner) is the common parent of an affiliated group of corporations (the group) making a consolidated return of income. By notice of deficiency, respondent determined a deficiency of $10,196,874 in the group's Federal income tax for its 1997 taxable (calendar) year and also denied a claim for refund of $786,804. The issues for decision are whether respondent properly (1) denied the claim for the refund, which is related to the creditability of the United Kingdom (U.K.) windfall tax paid by petitioner's indirect U.K.

subsidiary (the windfall tax issue), (2) included as dividend income a distribution that petitioner received from the same indirect U.K. subsidiary, but which, within a few days, the subsidiary rescinded and petitioner repaid (the dividend rescission issue), and (3) denied depreciation deductions that petitioner's U.S. subsidiary claimed for street and area lighting assets. We disposed of the third issue in a previous report, *PPL Corp. & Subs. v. Commissioner*, 135 T.C. ___ (2010), and we dispose of the remaining issues here.

Unless otherwise stated, all section references are to the Internal Revenue Code in effect for 1997, and all Rule references are to the Tax Court Rules of Practice and Procedure. With respect to the two issues before us here, petitioner bears the burden of proof. See Rule 142(a).[1]

FINDINGS OF FACT

Stipulations

The parties have entered into a first, second, and third stipulation of facts. The facts stipulated are so found. The stipulations, with accompanying exhibits, are incorporated herein by this reference.

Petitioner's Business and Its U.K. Operation

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[1] Petitioner has not raised the issue of sec. 7491(a), which shifts the burden of proof to the Commissioner in certain situations. We conclude that sec. 7491(a) does not apply because petitioner has not produced any evidence that it has satisfied the preconditions for its application. See sec. 7491(a)(2).

Petitioner is a Pennsylvania corporation that was known during 1997 as PP&L Resources, Inc. It is a global energy company. Through its subsidiaries, it produces electricity, sells wholesale and retail electricity, and delivers electricity to customers. It provides energy services in the United States (in the Mid-Atlantic and the Northeast) and in the United Kingdom. During 1997, South Western Electricity plc (SWEB), a U.K. private limited liability company, was petitioner's indirect subsidiary.[2] Its principal activities at the time included the distribution of electricity. It delivered electricity to approximately 1.5 million customers in its 5,560-square-mile service area from Bristol and Bath to Land's End in Cornwall. SWEB also owned electricity-generating assets.

Privatization of U.K. Companies

The Conservative Party won control of the U.K. Parliament in the 1979 elections. It retained control through May 1997, under the leadership of Margaret Thatcher and John Major.

Between 1979 and 1983, the Conservatives privatized mostly companies that were not monopolies (e.g., manufacturing companies) and, for that reason, did not require specific economic regulation. Between 1984 and 1996, however, the U.K. Government privatized more than 50

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[2] SWEB was originally incorporated as a U.K. public limited liability company in 1987, but, as described *infra*, it was privatized in 1990. The appendix shows SWEB's relationship to petitioner in 1997.

Government-owned companies, many of which were monopolies.

The U.K. Government privatized those companies largely through public flotations (share offerings) at fixed price offers, which involved the transfer of those Government-owned enterprises to new public limited companies (plcs), followed by what was essentially a sale of all or some of the shares in the new plcs to the public.[3] The plcs then

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[3] The U.K. Government hired investment banks and other advisers to assist it in setting the initial share prices, structuring the offers, and marketing the shares to investors. The new plcs were not subject to a gains tax on transfers of stock to the general public, a result made possible by an amendment to the then-existing U.K. law.

Under sec. 171 of the U.K. Taxation of Chargeable Gains Act, 1992 (TCGA), companies within a group (generally, a parent and its 75-percent-owned subsidiaries) may transfer assets between members of the group without incurring a capital gains charge. The effect of TCGA sec. 171 is to defer the chargeable gain on asset appreciation until a group member transfers the asset outside the group, at which point the gain becomes chargeable to that transferor. Under the TCGA as originally enacted, however, the transfer outside the group of the *stock* of a group member holding an appreciated asset would not trigger any capital gains charge to the transferor. (The nongroup transferee, meanwhile, would receive a basis in the stock that would reflect the value of the underlying asset.) TCGA sec. 179 was enacted to make the tax consequences of the stock transfer similar to those of the asset transfer, although only if the transfer of the stock of the group member holding the asset occurred within 6 years of that member's acquisition of the asset. Because the transfers of the stock of the privatized utilities to the general public pursuant to the flotations of that stock would have triggered the application of TCGA sec. 179 and taxation of the appreciation inherent in the

became publicly traded companies listed on the London Stock Exchange. In most cases, the floated shares opened for trading at a substantial premium over the price the flotation investors paid for the shares.

In December 1990, the U.K. Government privatized 12 regional electric companies (RECs), including SWEB. The ordinary shares of each REC were offered to the public at £2.40 per share in connection with the flotation of those shares.

The 32 U.K. Government-owned companies that were privatized and that ultimately became liable for the windfall tax (the privatized utilities or windfall tax companies) and the years in which they were privatized are as follows:

Year	Company
1984	50.2 percent of British Telecommunications plc (British Telecom)
1986	British Gas plc
1987	British Airports Authority
1989	10 water and sewerage companies (the WASCs)
1990	The 12 RECs

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assets the companies received from the various U.K. Government-owned enterprises, Parliament specifically exempted the privatization share transfers from the application of that provision.

1991	60 percent of National Power plc and Powergen plc (the generating companies)
1991	Scottish Power plc and Scottish Hydro-Electric plc (the Scottish electricity companies)
1993	Northern Ireland Electricity (NIE)
1996	Railtrack plc (Railtrack)
1996	88.5 percent of British Energy plc (British Energy) (which owned U.K. nuclear generating stations)

Regulation of the Windfall Tax Companies

The Electricity Act of 1989, c. 29, sec. 1, created the position of U.K. Director General of Electricity Supply, a position that Professor Stephen C. Littlechild (Professor Littlechild) held from its creation in 1989 through 1998.[4]

Before that appointment, in 1983, the U.K. Secretary of State asked Professor Littlechild for his advice on how to regulate British Telecom in the light of its impending privatization. Professor Littlechild recommended a regulatory scheme which regulated prices rather than, as in the United States, maximum profits or rates of return. The premise of the scheme, which became known as "RPI

[4] Professor Littlechild was professor of commerce and head of the Department of Industrial Economics and Business Studies, University of Birmingham (on leave, 1989 to 1994) from 1975 to 1994 (and honorary professor from 1994 until 2004).

– X",[5] was that, if the Government fixed prices (but not profits) for a set number of years, the privatized companies would have an incentive to reduce costs to maximize profits during that period. Prices would be reset (presumably downward) at the start of the next regulatory period, to garner for consumers the fruits of the prior period's cost reductions. Profits might in a sense become excessive during any regulatory period (because a company achieved greater-than-anticipated savings and there was no mechanism for mid-period correction), but balance would be reestablished at the start of the next period. The goal was to increase efficiency, encourage competition, and protect consumers. Under RPI – X, prices were not allowed to increase during the regulatory period, except to allow for inflation (i.e., increases in RPI) less an amount (the X factor, which did not vary during the period) intended to reflect expected, increasing efficiency.

The U.K. Government set the X factors for the first regulatory periods, just before the initial privatization, to be effective for what was, in most cases, the 5-year period after privatization. Industry regulators subsequently reset the X factors, typically every 4 or 5 years. In some cases, particularly where investment requirements were high (e.g., in the case of companies that had underinvested while under public ownership), the X factor might be positive

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[5] RPI, which stands for retail price index, is comparable to the CPI (consumer price index) used for various purposes in the United States.

(RPI + X). That was the case for most of the RECs and WASCs.

Each of the regulatory bodies for the privatized utilities followed the RPI - X regulatory method, which was adopted for 29 of the 32 windfall tax companies, the exceptions being the generating companies. On March 31, 1990, the RPI – X methodology as applied to the RECs came into effect for the 5-year period ending March 31, 1995. As noted *supra*, because the RECs were in need of large capital expenditures during the initial 5-year period, the U.K. Government set price controls for the RECs in the form of RPI + X; i.e., it provided for annual increases in electricity distribution charges above the rate of inflation rather than reductions in those charges.

Utility Profits, Share Prices, and Executive Compensation During the Initial Postprivatization Period

During the initial postprivatization period (the initial period), the privatized utilities were able to increase efficiency and reduce operating costs to a greater degree than had been expected when the initial price controls were established. That ability led to higher-than-anticipated profits,[6] which, in turn, led to higher-than-anticipated dividends and

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[6] Among the privatized utilities, the RECs and the WASCs were particularly profitable during the initial period in that they recovered nearly all (over 90 percent for the WASCs and over 80 percent for the RECs) of their shareholders' initial investment at flotation within the first 4 years.

share price increases for the privatized utilities. The large profits, dividends, and share price increases resulted in sharply increased compensation for utility directors and executives, which, in some cases, arose through their share ownership and through bonus schemes. The popular press referred to those executives as "fat cats".

The public viewed the privatized utilities' initial period profits as excessive in relation to their flotation values. It also viewed the initial period compensation paid to the directors and executives of those companies as excessive. Those concerns, as well as the increases in dividends and share prices, resulted in considerable public pressure on the utility industry regulators to intervene and take action that would result immediately in lower prices, before the expiration of the initial 5-year period. But because the incentive for increased efficiency (and, ultimately, lower prices) depended on the regulators' not intervening until the end of the defined price control period, the regulators resisted that pressure and did not act until the end of the initial period, at which point they did tighten price controls and thereby transfer the benefit of reduced prices to utility customers. Despite those price adjustments, the public retained a strong feeling that the privatized utilities had unduly profited from privatization and that customers had not shared equally in the gains therefrom.

Development of the Windfall Tax

Although the Labour Party had been fundamentally opposed to privatization, particularly with respect to the utilities, by 1992 the party

reasoned that, because it would be costly and, given that much of the voting public had embraced share ownership, potentially unpopular, renationalization of those companies (when the party regained control of the Government) was unrealistic. The issue, then, was how the party might best channel the public concerns into developing policy.

As early as 1992, the British press reported that the policy of an incoming Labour Party might include "a 'windfall' tax on the profits of privatized utilities such as gas and electricity." By 1994 the idea of a windfall tax had become a regular feature in all Labour Party speeches and programs, and, in 1997, the party campaigned on a platform promising that it would (1) impose a windfall tax on the previously privatized utilities and (2) implement a welfare-to-work youth employment training program that the windfall tax would fund. Specifically, the Labour Party's 1997 Election Manifesto contained the following promise:

> We will introduce a Budget * * * to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities * * *.

In May 1996, before the issuance of that manifesto, certain members of the Labour Party's shadow treasury team, which included Geoffrey Robinson (Mr. Robinson), a Member of Parliament, began designing the U.K. windfall tax legislation that the party would introduce to Parliament in the

likely event that it won the 1997 election. To that end, Mr. Robinson commissioned members of the tax consulting firm Arthur Andersen (the Andersen team) to assist the Labour Party's shadow treasury team in developing the tax. The Andersen team consisted principally of Stephen Hailey, Christopher Osborne (Mr. Osborne), and Christopher Wales (Dr. Wales). The tax that the Andersen team devised was essentially the windfall tax that Parliament enacted in July 1997. Mr. Osborne and Dr. Wales were the most involved members of the Andersen team.

During their initial consideration of the design of the windfall tax, the Andersen team proposed three "simple" and three "complex" solutions for structuring the tax. The "simple" solutions were to tax either (1) turnover (gross receipts), (2) assets, or (3) profits. The "complex" solutions were to tax (1) excess profits, (2) excess shareholder returns, or (3) a "windfall" amount. The team members rejected the three "simple" solutions and the first two "complex" solutions for a variety of reasons. For example, they considered that a straightforward tax on profits, if prospective, would pose a risk of financial manipulation by the target companies (and, therefore, uncertainty as to its yield), a risk of public perception that it would compromise existing corporate tax reliefs, and, if retrospective, a risk of criticism that it constituted a second tax on the same profits. And although Mr. Robinson and the Andersen team considered that there was ample rationale for a straightforward tax on either excess profits or excess shareholder returns, they concluded that the negative aspects (e.g., the difficulty in computing the "excess" amounts, the need for a

retrospective tax to be assured of raising a target amount, and, in the case of a tax on excess shareholder returns, the likelihood of taxing the wrong shareholders, i.e., shareholders who did not realize those returns) outweighed the positive ones.

As a result of the perceived difficulties with the other approaches, Mr. Robinson and the Andersen team settled on the idea of a tax that would be a one-time (or, in U.K. parlance, a "one-off") tax on the "windfall" to the privatized utilities on privatization. The approach would be to impute a value to each company at privatization, using an appropriate price-to-earnings ratio for each company's profits during the first 5 years after flotation, recognize the "windfall" (the difference between the imputed value and the flotation price) as value forgone by taxpayers, and tax the privatized utilities on that "windfall" using established principles from capital gains tax legislation.[7] They reasoned that such a tax

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[7] In November 1996, in a presentation to Gordon Brown (Labour's next Chancellor of the Exchequer) and the Labour Party's shadow treasury team, the Andersen team set forth the average price-to-earnings ratios for the various privatized utility groups during the first 5 years after privatization, which ranged from a high of 12.7 after-tax and 9.4 pre-tax (both for the Scottish Electricity companies) to a low of 9.4 after-tax (for the WASCs) and 7.3 pre-tax (for the RECs). The presentation also set forth the potential revenue yield from using price-to-pre-tax earnings ratios of 6 through 8 to ascertain the imputed values of the companies and showed that a potential revenue yield of £6.4 billion could be achieved by using for that purpose either a pre-tax ratio of 6 or an after-tax ratio of 8.25 coupled with a 33-percent windfall tax rate on the excess of the imputed value over the flotation price.

would factor in the privatized utilities' "excess" profitability, the discount on privatization, the unanticipated efficiency gains, and the perceived weakness of the initial regulatory regime.

In November 1996, the foregoing proposal was reviewed and approved by Gordon Brown (who became Chancellor of the Exchequer when Labour returned to power in 1997) and the Labour Party's shadow treasury team, and, after the Labour Party regained power in 1997, by the U.K. Treasury Department, Inland Revenue, and the Parliamentary drafters (who drafted the actual legislative language), after which the draft legislation was disseminated to members of Parliament and enacted in July 1997.

Description of the Windfall Tax

On July 31, 1997, Parliament enacted the windfall tax. It constituted part I of chapter 58, Finance (No. 2) Act 1997 (the Act), and provided, in clause 1, as follows:

> 1.—(1) Every company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation shall be charged with a tax (to be known as the "windfall tax") on the amount of that windfall.
>
> (2) Windfall tax shall be charged at the rate of 23 per cent.
>
> (3) Schedule 1 to this Act (which sets out how to quantify the windfall from which

a company was benefitting on 2nd July 1997) shall have effect.

Clause 2 makes clear that the windfall tax is to apply to the 32 privatized utilities, clause 3 provides for the administration of the tax by the Commissioners of Inland Revenue, clause 4 covers the relationship between the windfall tax and profit-related pay schemes under the then-existing U.K. law, and clause 5 sets forth the definitions of terms used in part I.

Paragraphs 1 and 2 of schedule 1, referred to in clause 1(3), provide in pertinent part as follows:

> 1.—(1) * * * where a company was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation, the amount of that windfall shall be taken for the purposes of this Part to be the excess (if any) of the amount specified in subparagraph (2)(a) below over the amount specified in sub-paragraph (2)(b) below.
>
> (2) Those amounts are the following amounts * * *, that is to say—
>
> (a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and
>
> (b) the value which for privatization purposes was put on that disposal.

Value of a disposal in profit-making terms

2.—(1) * * * the value in profit-making terms of the disposal made on the occasion of a company's flotation is the amount produced by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio.

(2) For the purposes of this paragraph the average annual profit for a company's initial period is the amount produced by the following formula—

$$A = 365 \times P/D$$

Where—

A is the average annual profit for the company's initial period;

P is the amount * * * of the total profits for the company's initial period; and

D is the number of days in the company's initial period.

(3) For the purposes of this paragraph the applicable price-to-earnings ratio is 9.

Paragraph 3 defines "value put on a disposal for privatisation purposes"; i.e., the flotation value. Paragraph 4 provides for an appropriate percentage reduction of a company's "value in profit-making terms" and its flotation value where less than 85 percent of the company's ordinary share capital was "offered for disposal on the occasion of the company's flotation." Paragraph 5 sets forth the criteria for determining a company's "total profits for a company's initial period" and generally provides that those profits are its after-tax profits for financial

reporting purposes as determined under relevant provisions of the U.K. Companies Act 1985.[8] Paragraph 6 defines the term "initial period" in relation to a company as the period encompassing the company's 4 financial years after flotation or such lesser period of existence for companies operating for less than 4 financial years after privatization and before April 1, 1997.[9] Paragraph 7 provides for the apportionment of the windfall amount subject to tax between companies that previously had been a single privatized company. Lastly, paragraph 8 defines the term "financial year" and other terms for purposes of the windfall tax legislation.

The Act required that affected companies pay the windfall tax in two installments: one-half on or before December 1, 1997, and the other half on or before December 1, 1998.

Public Statements Regarding the Windfall Tax

On July 2, 1997, Gordon Brown, then Chancellor of the Exchequer, gave the Budget Speech

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[8] The parties stipulate that profit for a windfall tax company's initial period was equal to the company's "profit on ordinary activities after tax" as determined under U.K. financial accounting principles and standards and as shown in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act of 1985, as amended.

[9] From this point forward, the term "initial period" refers to the 4-year windfall tax initial period rather than the 5-year initial postprivatization period under the RPI – X regulatory regime.

announcing the windfall tax, and he described the windfall tax as follows:

> Our reform to the welfare state—and the programme to move the unemployed from welfare to work—is funded by a new and one-off windfall tax on the excess profits of the privatised utilities.
>
> * * *
>
> In determining the details of the tax, I believe I have struck a fair balance between recognising the position of the utilities today and their undervaluation and under-regulation at the time of privatisation.
>
> The windfall tax will be related to the excessively high profits made under the initial regime.
>
> A company's tax bill will be based on the difference between the value that was placed on it at privatisation, and a more realistic market valuation based on its after-tax profits for up to the first 4 full accounting years following privatisation.

Also on July 2, 1997, Inland Revenue issued an announcement describing the tax as follows:

> The Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities. The one-off tax will apply to companies privatised by flotation and regulated by statute. The tax will be charged at a rate of 23 per cent on the difference between company value, calculated by reference to

> profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation. The expected yield is around 5.2 billion Pounds.

The Inland Revenue announcement also stated that the price-to-earnings ratio of 9 "approximates to the lowest average price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector."

Around that same time, Her Majesty's Treasury issued a publication entitled "Explanatory Notes: Summer Finance Bill 1997", which describes in detail the various clauses of the windfall tax, and which contains a section entitled "Background", stating:

> The introduction of the windfall tax is in accordance with the commitment in the Government's Election Manifesto to raise a tax on the excess profits of the privatised utilities.
>
> The profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.
>
> The windfall tax will raise around £5.2 billion and fund the Government's welfare to work programme.

Parliamentary Debate Preceding Enactment of the Windfall Tax

Mr. Robinson, in opening the debate in the House of Commons on the windfall tax legislation, offered the following introductory observations:

> Clause 1 heads a group of provisions that together introduce the windfall tax, thus meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities. Those companies were sold too cheaply, so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatisation was too lax, so the customer got a bad deal.
>
> As a result, the companies were able to make profits that represented an excessive return on the value placed on them at the time of their flotation. We are now putting right the failures of the past by levying a one-off tax. The yield of around £5.2 billion will fund our welfare-to-work programme, and the new deal that we have announced for the young long-term unemployed and schools.
>
> Clause 1 provides a one-off charge, set at a rate of 23 per cent. It also gives effect to schedule 1, which will be debated in Standing Committee. It may be helpful if I set the clause in context by explaining briefly how the windfall tax works.

> Windfall tax is charged on the difference between the value of the company, calculated by reference to the profits made in the initial period after privatisation, and the value placed on the company at the time of privatisation. The value of the company is calculated by multiplying the average annual profit after tax for, normally, the first four financial years after flotation, by a price-to-earnings ratio of nine. That ratio approximates to the lowest average * * * sectoral price-to-earnings ratio of the companies liable to the tax. * * *

The Conservative Party Shadow Chancellor of the Exchequer, Peter Lilley, MP (Mr. Lilley), summarized his party's opposition to the windfall tax, and, in particular, clause 1 imposing the tax, as follows:

> We have four major criticisms of the clause and the windfall tax that it initiates. First, the clause makes it clear that the tax will not be borne by the so-called fat cats and speculators, criticisms of whom justified its introduction. Secondly, it makes no meaningful attempt to define what is a windfall and should therefore bear the tax. Thirdly, it increases instead of reduces cost to customers; any improved profitability should be passed on to customers in the form of lower prices. Finally, it is retrospective, arbitrary and symptomatic of the Government's belief in arbitrary government, rather than in government by known and predictable rules.

Mr. Lilley's comments during the debate illustrate his understanding of how the tax would affect the privatized utilities:

> They [the government] have taken average profits over four years after flotation. If those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess. * * *

And further:

> Essentially, the windfall tax boils down to a tax on success. Companies that failed to improve their profitability over the said period will pay much less or even no windfall tax. * * *

Other members of the Conservative Party repeated the idea that the windfall tax was a tax on profits or on success.

Several Labour Party members defended the tax as a legitimate method of recouping the difference between what should have been charged for the privatized utilities at the time of the various privatizations and the actual flotation prices. For example, one such member, Mr. Hancock, observed:

> The overwhelming majority of people have embraced the tax because most think that they were ripped off in the first place when the companies were sold. The companies were sold at hopelessly undervalued prices at a time when most people felt that the companies were better and safer in the hands of the public sector. The legitimacy of the tax among the general public is that

> they feel that they are getting back what they should have had in the first place.

Another, Mr. Stevenson, echoed Mr. Hancock's remarks:

> I asked the Library to do some research on the difference between the proceeds from privatization of the utilities, not including the railways, and their stock market share price the minute they were floated. I asked the Library to tot up the difference. It was almost £6 billion at the outset of privatisation and it has increased over the years. So the snapshot figure of £6 billion by which the Government undersold public assets, and therefore robbed the public, is a conservative estimate.

Overall Effect of the Windfall Tax on the Windfall Tax Companies

Thirty-one of the thirty-two windfall tax companies had a windfall tax liability. None of the 31 companies that paid windfall tax had a windfall tax liability that exceeded its total profits over its initial period. Twenty-nine of those thirty-two companies had initial periods of 4 full financial years. Twenty-seven of those twenty-nine companies had initial periods consisting of 1,461 days, i.e., three 365-day years and one 366-day (leap) year. The other 2 of those 29 companies had initial periods of

1,456 days and 1,463 days,[10] respectively. The remaining three companies had initial periods of less than 4 full financial years, consisting of 1,380 days, 316 days, and (in the case of British Energy, which because of low initial profits, paid no windfall tax) 260 days, respectively.

Effect of the Windfall Tax on SWEB

Before the enactment of the windfall tax, SWEB met with members of the shadow treasury team (which included Mr. Robinson) and the Andersen team in an effort to influence the development of the windfall tax. SWEB's then treasurer, Charl Oösthuizen (Mr. Oösthuizen), was the SWEB officer principally engaged in that effort. Upon the announcement of the windfall tax, SWEB realized that its liability for the tax would greatly exceed its prior estimates thereof, and it investigated ways of reducing that liability. SWEB determined that it could reduce its windfall tax liability if it could reduce its earnings for the 4-year initial period. To that end, SWEB identified a theretofore unidentified liability of £12 million for tree-trimming costs (trees interfered with its distribution network) that SWEB should have taken account of in determining its earnings for its fiscal year ended March 31, 1995. SWEB's outside auditor approved a restatement of its 1995 earnings and, after an initial objection, Inland Revenue did as well.

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[10] The parties stipulated an initial period of 1,463 days, although that would seem to exceed 4 years, even taking into account a leap year.

SWEB filed its windfall tax return with Inland Revenue on November 7, 1997, and paid its £90,419,265 windfall tax liability (which was based on 4 full financial years totaling 1,461 days), as required, in two installments, on December 1, 1997 and 1998. The first installment was paid 1 day after the close of SWEB's tax year (for U.S. Federal income tax purposes) ending November 30, 1997.

OPINION

I. The Windfall Tax Issue

A. Principles of Creditability

Pursuant to section 901(a) and (b)(1), a domestic corporation may claim a foreign tax credit against its Federal income tax liability for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country". We must decide whether the windfall tax constitutes a creditable income or excess profits tax under section 901.

In *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 283-284 (1995), we described the background, purpose, and function of the foreign tax credit provisions of the Internal Revenue Code as follows:

> The foreign tax credit provisions were enacted primarily to mitigate the heavy burden of double taxation for U.S. corporations operating abroad who were subject to taxation in both the United States and foreign countries. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 9 (1932); *F.W. Woolworth Co. v. Commissioner*, 54 T.C.

1233, 1257 (1970). These provisions were originally designed to produce uniformity of tax burdens among U.S. taxpayers, irrespective of whether they were engaged in business abroad or in the United States. H. Rept. 1337, 83d Cong., 2d Sess. 76 (1954). A secondary objective of the foreign tax credit provisions was to encourage, or at least not to discourage, American foreign trade. H.R. Rept. 767, 65th Cong., 2d Sess. (1918), 1939-1 C.B. (Part 2) 86, 93; *Commissioner v. American Metal Co.*, 221 F.2d 134, 136 (2d Cir. 1955), affg. 19 T.C. 879 (1953).

Taxes imposed by the government of any foreign country were initially fully deductible in computing net taxable income, pursuant to our income tax law of 1913. Revenue Act of 1913, ch. 16, 38 Stat. 114. Specific foreign taxes became creditable pursuant to the Revenue Act of 1918. The foreign taxes that are presently creditable pursuant to section 901, specifically, income, war profits, and excess profits taxes, have remained unchanged and are the same taxes that were creditable in 1918. Revenue Act of 1918, ch. 18, sec. 222(a)(1), 40 Stat. 1073.

The definition of income, war profits, and excess profits taxes has evolved case by case. The temporary and final regulations, adopted relatively recently, outline the guiding principles established by prior case law. * * *

The Supreme Court in *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938), established the principle, uniformly followed in subsequent caselaw and enshrined in the regulations, that, in deciding whether a foreign tax is an "income tax" for purposes of section 901, the term "income tax" will be given meaning by referring to the U.S. income tax system and measuring the foreign tax against the essential features of that system:

> The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning * * *. It is that meaning which must be attributed to it * * *.

The final regulations referred to in *Phillips Petroleum* are the regulations that were issued in 1983, were in effect in 1997 (the year in issue), and remain in effect today (sometimes, the 1983 regulations).

Section 1.901-2, Income Tax Regs., is entitled "Income, war profits, or excess profits tax paid or accrued." Paragraph (a) thereof is entitled "*Definition of income, war profits, or excess profits tax*", and, in pertinent part, it provides as follows (adopting the term "income tax" to refer to an "income", "war", or "excess profits" tax):

> (1) In general. * * * A foreign levy is an income tax if and only if—
>
> (i) It is a tax; and
>
> (ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Paragraph (a) further provides that, with exceptions not relevant to this case, "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax."

In pertinent part, section 1.901-2(a)(3), Income Tax Regs., defines the term "predominant character" as follows: "The predominant character of a foreign tax is that of an income tax in the U.S. sense * * * [i]f, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies".

In pertinent part, section 1.901-2(b)(1), Income Tax Regs., provides:

> A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

Pursuant to section 1.901-2(b)(2)(i), Income Tax Regs. (as pertinent to this case), a foreign tax satisfies the realization requirement:

> if, judged on the basis of its predominant character, it is imposed * * * [u]pon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code * * *

Pursuant to section 1.901-2(b)(3)(i), Income Tax Regs. (as pertinent to this case), a foreign tax satisfies the gross receipts requirement "if, judged on the basis of its predominant character, it is imposed on the basis of * * * [g]ross receipts".

Pursuant to section 1.901-2(b)(4)(i), Income Tax Regs., a foreign tax satisfies the net income requirement:

> if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts * * * to permit—
>
> (A) Recovery of the significant costs and expenses * * * attributable * * * to such gross receipts; or
>
> (B) Recovery of such significant costs and expenses computed under a method that is likely to * * * [approximate or be greater than] recovery of such significant costs and expenses.

Section 1.901-2(b)(4)(i), Income Tax Regs., further provides:

> A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied,[11] unless the time of recovery is such that under the circumstances there is effectively a denial of

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[11] E.g., items deductible under the Internal Revenue Code and capitalized and amortized under the foreign tax system.

> such recovery. * * * A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. * * * A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. * * *

The Secretary first adopted the "predominant character" standard in the 1983 regulations. In the preamble to those regulations (the preamble), the Secretary stated that the standard:

> adopts the criterion for creditability set forth in *Inland Steel Company v. U.S.*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America National Trust and Savings Association v. U.S.*, 459 F.2d 513 (Ct. Cl. 1972), and *Bank of America National Trust and Savings Association v. Commissioner*, 61 T.C. 752 (1974). [T.D. 7918, 1983-2 C.B. 113, 114.]

In the cases the Secretary cited in the preamble and in other, more recent, cases, the issue or test

regarding the status of a foreign tax as a creditable income tax appears to be whether the foreign tax in question is designed to and does in fact reach net gain in the normal circumstances in which it applies. Thus, in *Bank of Am. Natl. Trust & Sav. Association v. United States*, 198 Ct. Cl. 263, 274, 459 F.2d 513, 519 (1972) (Bank of America I), which the Secretary cites in the preamble, the Court of Claims, in considering the creditability of a gross income tax that, on its face, was not a tax on net income or gain, concluded that such a tax could be creditable under certain circumstances:

> We do not, however, consider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit. The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives. In certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income. That would be the case if it were clear that the costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of the gross income. In that situation there would always (or almost so) be some net gain remaining, and the

> assessment would fall ultimately upon that profit.[12]

In *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 325, 677 F.2d 72, 80 (1982), also cited in the preamble, the Court of Claims, relying on its earlier decision in Bank of America I, emphasized the purpose of the foreign country in designing the tax to reach net gain:[13]

> To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which the tax applies. * * * The label and form of the foreign tax is not determinative. * * *

In *Bank of Am. Natl. Trust & Sav. Association v. Commissioner*, 61 T.C. 752, 760 (1974), affd. without published opinion 538 F.2d 334 (9th Cir. 1976), the

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[12] The test the Court of Claims adopted for the creditability of a foreign gross income tax (the virtual certainty of net gain) is specifically incorporated in the regulations. See sec. 1.901-2(b)(4)(i), Income Tax Regs., quoted *supra*.

[13] As the Court of Appeals for the Second Circuit stated in *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209, 216 (2d Cir. 1999) (Texasgulf II), affg. 107 T.C. 51 (1996) (Texasgulf I), the preamble to the 1983 regulations "reaffirms *Inland Steel*'s general focus upon the extent to which a tax reaches net gain". In Texasgulf II, the Court of Appeals found creditable under the predominant character standard in the 1983 regulations a tax, the Ontario Mining Tax, that the Court of Claims, in *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982), had found noncreditable before the promulgation of those regulations. See discussion *infra*.

third case the Secretary cites in the preamble, we described the analysis of the Court of Claims in Bank of America I as "[distilling]" the governing test to determine whether a foreign income tax qualifies as a creditable income tax within the meaning of section 901(b)(1); i.e., whether the tax was "designed to fall on some net gain or profit". That test, we added, "is the proper one to apply". *Id.*

Moreover, courts have construed the 1983 regulations in a manner consistent with the analysis in Bank of America I. For example, the Court of Appeals for the Second Circuit, in *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999) (Texasgulf II), affg. 107 T.C. 51 (1996) (Texasgulf I), considered the creditability of the Ontario Mining Tax (OMT), which imposed a graduated tax on Ontario mines to the extent that "profit", as defined for OMT purposes, exceeded a statutory exemption. In determining "profit" for OMT purposes, taxpayers were allowed to deduct "an allowance for profit in respect of processing" (processing allowance) in lieu of certain expenses that were attributable to OMT gross receipts but that were not recoverable under the tax (nonrecoverable expenses). The taxpayer had presented empirical evidence to show that, across the industry, the processing allowance was likely to exceed nonrecoverable expenses for the tax years at issue. In answer to the Commissioner's objection that the taxpayer had not shown anything more than an accidental relationship between the processing allowance and the nonrecoverable expenses, the Court of Appeals stated:

> At bottom, the Commissioner's argument is that the type of quantitative, empirical

> evidence presented in this case is not relevant to the creditability inquiry. However, the language of § 1.901-2—specifically, "effectively compensate" and "approximates, or is greater than"—suggests that quantitative empirical evidence may be just as appropriate as qualitative analytic evidence in determining whether a foreign tax meets the net income requirement. We therefore hold that empirical evidence of the type presented in this case may be used to establish that an allowance effectively compensates for nonrecoverable expenses within the meaning of § 1.901-2(b)(4).

Id. at 216 (fn. ref. omitted). The Court of Appeals concluded:

> Given the large size and representative nature of the sample considered, these statistics suffice to show that the Tax Court did not clearly err in finding that the processing allowance was likely to exceed nonrecoverable expenses for the tax years at issue. Texasgulf has therefore met its burden of proving that the predominant character of the OMT * * * is such that the processing allowance effectively compensates for any nonrecoverable costs.

Id. at 215-216.

In reaching their decisions, both the Court of Appeals and this Court distinguished *Inland Steel Co. v. United States*, *supra* (which held the same OMT to be noncreditable). The former distinguished

that case on the ground that it was decided before the promulgation of section 1.901-2, Income Tax Regs., and, in particular, before the adoption of the rule that a foreign tax law that "provides allowances that effectively compensate for nonrecovery of * * * significant costs or expenses * * * is considered to permit recovery of such costs and expenses." Texasgulf II, 172 F.3d at 216-217. We distinguished *Inland Steel* not only on that ground but also on the ground that the case was governed by the "predominant character" test, which replaced the "substantial equivalence" test under which *Inland Steel* was decided. Texasgulf I, 107 T.C. at 69-70. In reaching that conclusion we stated that use of the "predominant character" and "effectively compensates" tests represented "a change from the history and purpose approach used in cases decided before the 1983 regulations applied a factual, quantitative approach." *Id.* at 70.

In *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), we considered the creditability of the U.K. petroleum revenue tax (PRT) under section 901 and the 1983 regulations. We found that a purpose of the PRT was "to tax extraordinary profits of oil and gas companies relating to the North Sea." *Id.* at 344. With limited exceptions, the tax base subject to PRT was gross income relating to oil and gas recovery activities less "all significant costs and expenses, except interest expense".[14] *Id.* at 345. In lieu of an

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[14] The denial of a deduction for interest was designed to prevent the use of intercompany debt to avoid or minimize

interest expense deduction, the law provided a deduction for "uplift"; i.e., "amounts equal to 35 percent of most capital expenditures relating to a North Sea field". *Id.* at 347.

With respect to the predominant character of the tax, we found: "The purpose, administration, and structure of PRT indicate that PRT constitutes an income or excess profits tax in the U.S. sense." *Id.* at 356. We stated that the evidence at trial showed "that special allowances and reliefs under PRT significantly exceed the amount of disallowed interest expense for Exxon and other oil companies", and we quoted the testimony of the U.K. Government official who first presented PRT to the U.K. House of Lords for formal consideration that "'of course, this tax [PRT] represents an excess profits tax.'" *Id.* at 357. We rejected as irrelevant the Commissioner's contention that a company-by-company analysis showed that most of the companies operating in the North Sea did not have uplift allowance greater than or equal to the disallowed interest expense, and we agreed with Exxon that the "PRT was designed to tax excess profits from North Sea oil and gas production[,] which generally were earned by major oil and gas companies[,] which owned the largest and most profitable fields in the North Sea." *Id.* at 359. We then noted that the vast majority of those companies "had uplift allowance in excess of nonallowed

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liability for the tax. *Exxon Corp. v. Commissioner*, 113 T.C. 338, 345 (1999).

interest expense."[15] *Exxon Corp. v. Commissioner*, *supra* at 359. Finally, we concluded that "the predominant character of PRT constitutes an excess profits or income tax in the U.S. sense" creditable under section 901. *Id.*

B. Arguments of the Parties

1. Petitioner's Arguments

Petitioner argues that, given the historical development, design, and actual operation of the windfall tax, it constitutes a creditable tax on excess profits.

Petitioner rejects respondent's view that, in determining the creditability of the windfall tax, we are constrained by the text of the statute. Rather, petitioner argues that we may consider extrinsic evidence of the purpose and effect of the tax as applied to the windfall tax companies. As petitioner states: "The determination of whether a foreign tax is designed to fall on some net gain or profit depends

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[15] Earlier in *Exxon Corp. v. Commissioner*, *supra* at 352, in discussing the predominant character standard, we made the following observation regarding sec. 1.901-2, Income Tax Regs.:

> The regulations * * * provide that taxes either are or are not to be regarded as income taxes in their entirety for all persons subject to the taxes. See sec. 1.901-2(a), Income Tax Regs. Respondent does not interpret this provision as requiring that, in order to qualify as an income tax, a tax in question must satisfy the predominant character test in its application to all taxpayers. Rather, respondent interprets this provision as requiring that in order to qualify as an income tax a tax must satisfy the predominant character test in its application to a substantial number of taxpayers.

on the substance, and not the form or label, of the tax." In support of its position, petitioner relies, in large part, on the decisions of this Court in *Exxon Corp. v. Commissioner*, *supra*, Texasgulf I, and *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995), in each of which we considered evidence of the purpose, design, and operation of the foreign tax in question in considering creditability.

With respect to the development and design of the tax, petitioner offers the trial testimony of Professor Littlechild, two members of the Andersen team (Mr. Osborne and Dr. Wales), and an exhibit constituting Mr. Robinson's trial testimony in *Entergy Corp. v. Commissioner*, T.C. Memo. 2010-198, filed today, which also involves the creditability of the windfall tax. Petitioner notes that Professor Littlechild's testimony establishes that he designed the regulatory system (RPI – X) that allowed the privatized utilities to realize the higher-than-anticipated profits during the initial period after flotation. Petitioner also notes that both Mr. Osborne and Dr. Wales (members of the Andersen team who testified as experts regarding the regulatory and political concerns that led to enactment of the windfall tax) stated that (1) the rationale for the tax was the perceived excess profits the privatized utilities earned during the initial period and (2) the actual form of the tax was adopted for "presentational" reasons.[16] Mr. Robinson's testimony

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[16] Dr. Wales testified that, during a Nov. 6, 1996, meeting with Gordon Brown, the Andersen team "demonstrated the presentational linkage that could be made between the

in *Entergy* is consistent with that of Mr. Osborne and Dr. Wales, and it reaches the same principal conclusion: The intent was to tax the excess profits of the privatized utilities.

Petitioner also offers the testimony of Mark Ballamy (Mr. Ballamy) and Edward Maydew (Professor Maydew), both experts in accounting, the former the founder of a U.K. accounting firm, the latter a professor of accounting at the University of North Carolina. Petitioner claims that the sum and substance of Mr. Ballamy's testimony (which dealt with U.K. financial accounting concepts under the windfall profits tax statute) "establishes that the windfall tax fell on the excess profits of the Windfall Tax Companies during their initial periods and that all of these profits represented realized profits". Professor Maydew testified regarding U.K. and U.S. financial accounting concepts and that the windfall tax was, in substance, a tax on income, similar in operation to prior U.S. and U.K. excess profits taxes. Petitioner claims that Professor Maydew's testimony confirms that of Mr. Ballamy that the U.K. and U.S. concepts of realization are fundamentally the same, thereby satisfying the regulations' realization requirement.

Petitioner's final expert witness was Stewart C. Myers (Professor Myers), professor of finance at MIT's Sloan School of Management. Professor Myers' research and teaching focus is, in part, on the

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mechanics of the tax, * * * the underlying rationale for the tax [i.e., a tax on the privatized utilities' initial period excess profits] and the popular notion of undervalue at privatisation."

valuation of real and financial assets. Petitioner points to Professor Myers' testimony that the differences in windfall tax payments by the privatized companies cannot be explained by differences in flotation value or by changes in value after flotation and that the tax "operated as an excess-profits tax, not as a tax on value, change in value or undervaluation."[17]

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[17] As part of his testimony, Professor Myers employed a series of scatter plot diagrams to demonstrate that there was, at best, a very loose relationship between the windfall tax the privatized utilities paid and changes in their actual market values after privatization, but very tight and direct relationships between (1) the windfall tax payments and the cumulative initial period earnings of those companies and (2) the windfall tax payments and what Professor Myers determined to be the cumulative initial period excess profits of the RECs and the WASCs.

Professor Myers also testified that the term "value in profit-making terms", as defined in the windfall tax statute, is not a standard economic term or concept and it has no meaning in any other context. Moreover, he believes that it does not represent a true economic value of any of the privatized utilities; rather, he believes that it constituted "a one-off device created to determine tax liability." He further testified:

> The privatized companies were valued daily on the London Stock Exchange. The designers of the Windfall Tax could have used stock-market values to identify (with hindsight) the "undervaluation" of the companies on or after their IPO dates. Instead they settled on a formula in which the chief moving part was not value but profits.

Professor Myers rejects respondent's argument (discussed *infra*) that value in profit-making terms, because it is calculated using a reasonable price-to-earnings multiple, is the product of an acceptable valuation technique. In Professor Myers' view, "9 is not an accurate P/E multiple, and it is not

Petitioner also offered the fact testimony of Mr. Oösthuizen, SWEB's treasurer during the period leading up to the enactment of the windfall tax in 1997 and, before that, SWEB's tax manager. Mr. Oösthuizen recognized that, under the windfall tax formula, for every pound that profits were reduced in an initial period year, SWEB received 51 percent of that amount back as a reduction in its windfall tax liability. He also was involved in SWEB's decision to act on that knowledge by obtaining permission from its auditors (and, after an initial objection, Inland Revenue) to restate its accounts for its 1994-95 fiscal year (the final year of SWEB's initial period) by expensing (as a reserve) £12 million of projected tree-trimming costs, which saved SWEB over £6 million of projected windfall tax.[18] Petitioner also notes Mr. Oösthuizen's recognition that the windfall tax operated as an excess profits tax. In that regard, Mr. Oösthuizen testified as follows:

> In effect, the way the tax works is to say that the amount of profits you're allowed in any year before you're subject to tax is equal to one-ninth of the flotation price. After that, profits are deemed excess, and there is a tax. That's how the tax works. It has a definition of what is allowable profit and

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applied to current or expected future earnings * * * [Therefore,] 'value-in-profit-making terms' cannot measure the economic value that companies could, would, or should have had."

[18] Mr. Oösthuizen testified that a Government press release describing the windfall tax prompted SWEB to restate its accounts for its 1994-95 fiscal year.

what is excess profits, and it taxes the excess.

Lastly, petitioner notes that it is possible to restate the windfall tax formula algebraically to make clear that it operates as an excess profits tax imposed (on 27 of the 32 windfall tax companies) at an approximately 51.7-percent rate.[19] In that regard, petitioner points to a series of stipulations in which the parties agree that that is in fact the case.[20] In particular, petitioner points to the parties' stipulation that the windfall tax formula (for companies with a full 1,461-day initial period) can be rewritten pursuant to the following steps (where P is the total initial period profits and FV is the flotation value).

Statutory Windfall Tax Formula

$$\text{Tax} = 23\% \times [\{(365 \times (P/1{,}461)) \times 9\} - FV]$$

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[19] Mr. Oösthuizen and Professors Maydew and Myers make the same point.

[20] Respondent objects to certain of those stipulations on the ground that the reformulations are neither (1) "the statutory equivalent of the equation set forth in the [Windfall Tax] Act" nor (2) "an appropriate application of the equation in the Act", and on the further ground that the stipulations are "irrelevant and immaterial." Respondent does not object to the mathematical equivalence of the reformulations.

Windfall Tax Formula—Modification (1)

Tax = 23% x [{(P/4[21]) x 9} – FV)]

Windfall Tax Formula—Modification (2)

Tax = 51.71% x {P – (44.47% x FV)}[22]

Petitioner also points out that, instead of a cumulative reformulation of the windfall tax for the entire initial period, the tax can be reformulated by showing its application with respect to each year of that period as follows (where P1, P2, etc. represent profits for year 1, year 2, etc.).

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[21] For the sake of simplicity here and in modification (2), 1,461 days divided by 365 days is deemed to equal 4 rather than the more accurate 4.0027397.

[22] Again, for the sake of simplicity, 44.47 percent represents (1,461/365)/9 or approximately 0.4447489 (which is approximately 4/9), and the 51.71 percent represents {9/(1,461/365)} x 23 percent or approximately 0.5171458 (which is approximately 9/4 of the 23-percent windfall tax rate). As Professor Myers points out, to get from modification (1) to modification (2), one need only multiply all terms inside the brackets (in modification (1)) by 4/9 and the 23 percent tax rate by 9/4 with the windfall tax amount remaining unchanged, because (4/9) x (9/4) = 1.

$$\text{Tax} = 51.71\% \times \{P1 - (11.11\% \times FV)\}$$
$$+ 51.71\% \times \{P2 - (11.11\% \times FV)\}$$
$$+ 51.71\% \times \{P3 - (11.11\% \times FV)\}$$
$$+ 51.71\% \times \{P4 - (11.14\% \times FV)\}[23]$$

Petitioner argues that the foregoing mathematical and algebraic reformulations of the windfall tax as enacted show that, in substance, it was a tax imposed at a 51.71-percent rate "on the profits for each Windfall Tax company's initial period to the extent those profits exceeded an average annual return of approximately 11.1 percent of [the company's flotation value]."

Petitioner acknowledges, and the parties have stipulated (with respondent lodging the same objections regarding lack of statutory equivalency, appropriateness, relevancy, and materiality), that 5 of the 32 windfall tax companies had initial periods longer or shorter than 1,461 days and that, for those companies, the reformulated rates are different. For two of those companies, because the number of days in the initial period was very close to 1,461 days, the rate of the reformulated windfall tax was very close to 51.71 percent, and the 4-year return on flotation value to be exceeded for there to be a tax was very close to 44.47 percent. For NIE, which had an initial period of 1,380 days, those two rates were 54.75 percent and 42.01 percent, respectively. As noted *supra*, British Energy had no windfall tax liability

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[23] The 11.14 percent reflects the multiplier for the leap year of 366 days, assumed, for demonstrative purposes, to be year 4.

because of insufficient profits during the initial period. The fifth company, Railtrack, had an initial period of only 316 days, with the result that the effective tax rate on its excess profits (determined pursuant to the stipulated reformulation of the tax) was 239.10 percent, and the cumulative 4-year return on flotation value to be exceeded for there to be a tax was only 9.62 percent. Petitioner dismisses any concerns regarding the effect of the reformulated windfall tax on those 5 companies as compared to its uniform effect on the other 27 companies on several grounds: (1) For 2 of the companies, the differences are negligible; (2) any differences in effective rates "are not significant or material in evaluating the overall incidence of the Windfall Tax" because the 5 companies are outliers and, therefore, must be ignored for purposes of determining creditability under the section 901 regulations as applied by the Court of Appeals for the Second Circuit in Texasgulf II and this Court in Texasgulf I; (3) as Mr. Osborne explained, the payment of relatively large amounts of windfall tax by companies with initial periods of substantially less than 1,461 days (i.e., NIE and Railtrack) was not a problem because profits earned over the balance of what would have been a full 1,461-day period (referred to by Mr. Osborne as "out performance") would not be subject to the tax; and (4) the tax did not exceed the realized, after-tax profits of any of the windfall tax companies.

2. Respondent's Arguments

Respondent argues that the 1983 regulations alone control the creditability of the windfall tax because those regulations subsume or supersede prior caselaw and "neither require nor permit

inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute." Applying those regulations to this case, respondent concludes that, according to the actual terms of the windfall tax statute, the windfall tax failed to satisfy any of the tests that a foreign tax must satisfy to be considered "likely to reach net gain in the normal circumstances in which it applies"; i.e., the realization, gross receipts, and net income tests. Therefore, the windfall tax did not have the predominant character of an income tax in the U.S. sense. In essence, respondent's position is that, pursuant to the terms of the statute, the windfall tax "was not imposed upon or after the occurrence of a realization event for U.S. tax purposes because the * * * tax was not a direct additional tax on previously-realized earnings. Rather, the tax was imposed on the difference between two company values." As a tax imposed on a base equal to the unrealized difference between two defined values, rather than directly on realized gross receipts reduced by deductible expenses, respondent argues that it necessarily fails to satisfy any of the three tests.

Respondent flatly rejects petitioner's claim that, under the 1983 regulations, we may rely on extrinsic evidence "relating to * * * [the Windfall Tax's] purported purpose, design, and 'substance' revealed through petitioner's so-called 'algebraic reformulation' of the tax." Respondent argues that Texasgulf II, Texasgulf I, and *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), which did admit extrinsic evidence to demonstrate the creditability of foreign taxes, should be limited to their facts; i.e., a

finding that the alternative cost allowances under consideration in those cases "effectively compensated" for the nondeductibility of certain actual expenses pursuant to the requirements of section 1.901-2(b)(4)(i)(B), Income Tax Regs., and "do not support the use of extrinsic evidence to satisfy a requirement not found in the regulations."

Respondent also argues that we should disregard petitioner's algebraic reformulations of the windfall tax statute as merely "a hypothetical rewrite" of the statute, which does not constitute "'quantitative' or 'empirical' evidence" that the tax actually touched net gain, "as contemplated by this Court in *Texasgulf I* or *Exxon*." That argument, like his argument that we may not consider extrinsic evidence that the actual incidence of the tax was on net income or excess profits, follows from what appears to be the crux of respondent's position: The windfall tax is unambiguously imposed on the difference between two values and, therefore, it cannot be a tax on income or profit.[24]

Because for respondent "the 'substance' of the tax is revealed on the face of the Windfall Tax statute itself"—i.e., "[t]he words of the U.K. statute *are* the 'substance' of this tax"—he believes that it is not necessary to look beyond those words to give them meaning. Nevertheless, he argues that, even

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[24] Respondent makes the point on brief as follows: "The key evidence in this case—the Windfall Tax statute itself—explicitly provides that the Windfall Tax is imposed on a base of the difference between two values, and such formulation fails to satisfy the section 901 regulations."

assuming the intent of the Andersen team and members of Parliament might be relevant in characterizing the nature of the windfall tax, their intent is as consistent with the statute as written (i.e., a tax on value in excess of flotation proceeds) as it is with petitioner's view that the windfall tax was intended as a tax on excess profits. In support of that argument, respondent refers to Mr. Robinson's 2000 book describing his life as a member of the Labour Party, entitled "The Unconventional Minister", and quotes the following portion of chapter 6, which describes the development and enactment of the windfall tax:

> Then in October 1996 Chris Wales had a stroke of inspiration. Chris simply turned the whole argument on its head: the problem was not that the companies had made too much profit, nor that they had paid out too much to shareholders and fat-cat directors, nor that they had been treated with kid gloves by the regulators. That was all true of course: but the genesis of the problem was that they had been sold too cheaply in the first place. Why not then, argued Chris, tax the loss to the taxpayer which arose from the sale of these companies at what was a knock-down price.

In further support of his position that the windfall tax was indeed a tax on the difference between two defined values, respondent offers the expert testimony of Peter K. Ashton (Mr. Ashton), a consultant who was qualified as an expert in economics and valuation methodologies, and Philip Baker QC (Queens Counsel; Mr. Baker), a U.K. tax

lawyer offered as an expert in U.K. tax legislation and the U.K. tax system.

Mr. Ashton viewed the method of computing the statutory value in profit-making terms for each of the windfall tax companies as a generally accepted valuation methodology, which he referred to as the "market value multiples method for computing the equity value of a company." Although Mr. Ashton agreed that, in general, "valuation is a forward-looking proposition", he reasoned that the windfall tax methodology of fixing value retroactively was acceptable because the draftsmen selected a valuation date with respect to which they had "perfect foresight of what the income is going to be for * * * [the windfall tax companies] that you can plug in to the valuation formula."

The substance of Mr. Baker's testimony was that, by its terms, the windfall tax was for each windfall tax company a tax on a tax base equal to the difference between two defined values, and that, as such, it was distinguishable from prior or existing U.K. taxes on excess profits or capital gains.

Respondent echoes Mr. Baker's view that the windfall tax was intentionally imposed on a tax base measured, in part, by a value (the "value in profit-making terms") derived (retrospectively) from known initial period earnings and, for that reason, criticizes Professor Myers' reliance on "equity value or market capitalization value" as his standard for concluding that, in relying on "value in profit-making terms", the windfall tax was not a tax on value, as that term is conventionally understood. In respondent's view, we "need not determine whether the Profit-Making

Value formula resulted in a 'realistic' valuation of the Windfall Tax Companies in order to determine whether the Windfall Tax is a creditable tax." That is because, in respondent's view, profit-making value "represented a reasonable approximation of how the Windfall Tax Companies might have been valued at the time of flotation if subsequent earnings could have been known at that time."[25]

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[25] Relying on a point that the Andersen team made in a November 1996 presentation to Gordon Brown, respondent also argues, presumably as an alternative ground for denying a foreign tax credit for the windfall tax, that the tax was, in substance, a reenactment of TCGA sec. 179 (see the discussion of that provision in note 3 of this report); i.e., a retroactive tax on the unrealized appreciation of the windfall tax companies at the time of privatization. Respondent argues that, because the tax necessarily fails the realization test of the 1983 regulations, it is noncreditable. We find respondent's arguments unpersuasive for two reasons. First, respondent's own expert, Mr. Baker, specifically disavowed those arguments by flatly stating that the windfall tax "was not corporation tax. It was a separate tax and it was at the rate of 23 percent instead [of the 33 percent corporate tax rate]." Second, we agree with petitioner that, even if the windfall tax had been intended as (in substance) a reenactment of TCGA sec. 179, it would not be a tax on unrealized appreciation; rather it would be a tax on previously realized but unrecognized gain and, therefore, creditable. As petitioner points out: "the operation of section 171 TCGA and section 179 TCGA is substantively similar to the gain deferral and recognition rules relating to intercompany transfers in our consolidated return regulations, section 1.1502-13, Income Tax Regs." Petitioner argues, however, that "[t]he Windfall Tax statute was not designed on the basis of Section 179 TCGA. Respondent's argument on this basis is unfounded." We accept what is, in effect, petitioner's concession that the windfall tax should not be considered an income tax because it resembled, or was a reinstatement of,

C. Analysis

1. Introduction

The parties fundamentally disagree as to what we may consider in determining whether the windfall tax is a creditable tax for purposes of section 901. Respondent's view is that we need not (indeed, may not) consider anything other than the text of the windfall tax statute in determining whether that tax is an "income tax" within the meaning of section 1.901-2(a), Income Tax Regs. "[B]ased on * * * the simple formula employed to levy the tax", respondent argues, the windfall tax falls on the difference between two values—"Flotation Value" and "Profit-Making Value". It is, respondent continues, therefore a tax on value (and not on income). "Petitioner", respondent concludes, "cannot escape from the plain language of the [windfall tax] statute."[26]

TCGA sec. 179. Therefore, we do not decide the windfall tax issue on that ground.

[26] "In construing a statute", respondent argues, "the 'preeminent canon of statutory interpretation requires a court to "presume that [the] legislature says in a statute what it means and means in a statute what it says there."'" (quoting *BedRoc Ltd., LLC v. United States*, 541 U.S. 176, 183 (2004) (quoting *Conn. Natl. Bank v. Germain*, 503 U.S. 249, 253-254 (1992))). Respondent insists that "'when the statute's language is plain, "the sole function of the courts"—at least where the disposition required by the text is not absurd—"is to enforce it according to its terms."'" (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (quoting *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989)).

Petitioner, points out that, under the cited regulation, it is the "predominant character" of the foreign tax in question that counts. To determine the predominant character of the windfall tax, petitioner argues that we may consider evidence beyond the text of the statute; viz, evidence of the design of the tax and its actual economic and financial effect as it applies to the majority of the taxpayers subject to it. In support of that argument, petitioner principally relies on three cases this Court has decided since the promulgation of the 1983 regulations: *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), Texasgulf I, and *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

For the reasons that follow, we think that petitioner has the better argument, and we find that the windfall tax is a creditable income tax under section 901.

2. Nature of the Predominant Character Standard

Respondent's text-bound approach to determining the creditability of the windfall tax is inconsistent with the 1983 regulations' description of the predominant character standard for creditability under which "the predominant character of a foreign tax is that of an income tax in the U.S. sense * * * [i]f * * * the foreign tax is likely to reach net gain in the normal circumstances in which it applies". Sec. 1.901-2(a)(3)(i), Income Tax Regs. By implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations clearly signaled their intent that factors extrinsic to the text of the

foreign tax statute play a role in the determination of the tax's character. In determining the predominant character of a foreign tax, we may look to the actual effect of the foreign tax on taxpayers subject to it, the inquiry being whether the tax is designed to and does, in fact, reach net gain "in the normal circumstances in which it applies", regardless of the form of the foreign tax as reflected in the statute.

That interpretation of the regulations' predominant character standard is consistent with caselaw preceding the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the "criterion for creditability" embodied in that standard: *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982), and Bank of America I (see *supra* p. 27 of this report). In the former case, the Court of Claims stated that a foreign tax will qualify as an income tax in the U.S. sense if the foreign country has "made an attempt always to reach some net gain in the normal circumstances in which the tax applies. * * * The label *and form* of the foreign tax is not determinative." *Inland Steel Co. v. United States*, *supra* at 325, 677 F.2d at 80 (emphasis added). The court noted that the issue, as framed under its analysis in Bank of America I, is "whether taxation of net gain is the ultimate objective *or effect* of * * * [the foreign] tax." *Inland Steel Co. v. United States*, *supra* at 326, 677 F.2d at 80 (emphasis added). In Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519 (emphasis added), the Court of Claims stated: "The important thing is whether the other country is attempting to reach

some net gain, *not the form in which it shapes the income tax or the name it gives.*"

The facts and analysis of the Court of Claims in Bank of America I nicely illustrate the prevailing pre-1983 standard. The case involved in part the creditability of foreign taxes on the taxpayer's gross income from the banking business its branch conducted in each of certain foreign countries. Clearly, a gross income tax is not, by its terms, a net income tax. Had the Court of Claims focused solely on the statutory language, which, in each case, levied a tax on the taxpayer's "gross takings" or "gross receipts" before deduction of any expenses, it would have been compelled to hold, on that ground alone, that none of the taxes under consideration constituted a creditable net income tax. The focus of the court's inquiry, however, was not on the text of the statute per se, but on the question of whether the tax was "attempting to reach some net gain". *Id.* The court specifically noted that "a levy can in reality be directed at net gain even though it is imposed squarely on gross income." *Id.* Relying on prior judicial decisions, Internal Revenue Service rulings, and gross income tax levies under Federal law (e.g., sections 871 and 1441), the court concluded that an income tax under section 901 "covers all foreign income taxes designed to fall on some net gain or profit, and includes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit." *Id.* at 281,

459 F.2d at 523.[27] Because the gross income taxes in Bank of America I failed to meet that test, the court held that they were noncreditable. *Id.* at 283, 459 F.2d at 524-525.

Also, as noted *supra*, the cases that have applied the 1983 regulations' predominant character standard are consistent with the Court of Claims' approach to creditability in *Inland Steel* and Bank of America I. Thus, in Texasgulf I, and in *Exxon Corp. v. Commissioner*, *supra*, we relied on quantitative, empirical evidence of the actual effect of the foreign tax on a majority of the taxpayers at whom it was directed and found that, in each case, the tax was designed to, and did, in fact, reach net gain and, therefore, constituted a creditable income or excess profits tax. In Texasgulf I, we distinguished the result in *Inland Steel Co. v. United States*, *supra*, which had held the tax under consideration (the Ontario Mining Tax) to be noncreditable, stating: "The use of the 'predominant character' and 'effectively compensates' tests in section 1.901-2(b)(4), Income Tax Regs., is a change from the history and purpose approach used in the cases decided before *the 1983 regulations applied a factual, quantitative approach.*" Texasgulf I, 107 T.C. at 70 (emphasis added).

We reject respondent's argument that this Court, in Texasgulf I and *Exxon*, and the Court of

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[27] As noted *supra* note 12, the Court of Claims' test for the creditability of a gross income tax is incorporated into the 1983 regulations. See sec. 1.901-2(b)(4)(i), Income Tax Regs.

Appeals for the Second Circuit, in Texasgulf II, "strictly limit the use of empirical data to an analysis under the alternative cost recovery method of the net income requirement of * * * [section 1.901-2(b)(4)(i)(B), Income Tax Regs.]." It is true that Texasgulf I, Texasgulf II, and Exxon involved the creditability of foreign taxes that started with a statutory tax base consisting of gross income, and that all three relied on extrinsic evidence to show that the foreign law's allowances in lieu of deductions for expenses actually incurred would "effectively compensate for nonrecovery of * * * significant costs or expenses", as required by section 1.901-2(b)(4)(i), Income Tax Regs. We disagree, however, with respondent's conclusion that those cases "do not support the use of extrinsic evidence to satisfy a requirement not found in the regulations." Nothing in those cases would so limit a taxpayer's right to rely on extrinsic evidence to demonstrate the creditability of a foreign tax and, specifically, that it satisfied the predominant character standard. In Texasgulf I, Texasgulf II, and *Exxon*, the narrow issue was whether the statutory allowances in question did, in fact, "effectively compensate" for the nondeductibility of "significant costs or expenses" within the meaning of section 1.901-2(b)(4)(i), Income Tax Regs. But the overall issue for decision in those cases, as in this case, was whether the foreign tax was designed to and did, in fact, reach net gain. The only limitation on reliance on extrinsic evidence in any of the three opinions in those cases is the following observation by the Court of Appeals for the Second Circuit in Texasgulf II, 172 F.3d at 216 n.11:

> We note, however, that this case is exceptional, in that the relatively small number of taxpayers subject to the OMT made it practicable to compile and present broadly representative industry data spanning a lengthy period. We do not suggest that the reliance that we place on empirical evidence would be appropriate in cases where such comprehensive data is unavailable.

Far fewer taxpayers were subject to the windfall tax than were subject to OMT in Texasgulf II, and the data (after-tax financial profits)[28] for the taxpayers subject to the windfall tax were readily available in the published financial reports of those taxpayers.

Respondent's argument that we should restrict our inquiry to the text of the windfall tax to

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[28] Although respondent states that "[t]he use of financial book earnings, rather than 'taxable income,' in determining the Windfall Tax Companies['] Profit-Making Value further distinguishes the Windfall Tax from a U.S. excess profits tax", he does not argue that a foreign tax on financial profits is noncreditable for that reason alone. That argument would appear to be invalid, in any event, in the light of our own corporate alternative minimum tax, which at one time was calculated, in part, using financial or book earnings. See sec. 56(f), repealed in 1990 by the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, sec. 11801(a)(3), 104 Stat. 1388-520. Moreover, differences between book and taxable income are, with rare exception, attributable to timing differences, which are generally disregarded under the 1983 regulations. See sec. 1.901-2(b)(4)(i), Income Tax Regs.

determine its predominant character is unpersuasive.

3. The Predominant Character Standard as Applied to the Windfall Tax

The term "value" may mean, among other things, either "Monetary or material worth" or, in mathematics, "An assigned or calculated numerical quantity." The American Heritage Dictionary of the English Language 1900 (4th ed. 2000). The parties do not disagree that the amount of the windfall for purposes of determining the windfall tax is, in mathematical terms, the excess (if any) of one value (value in profit-making terms) over another (flotation value). Nor do they disagree that flotation value is real or actual value (a value in the first sense). They do disagree as to whether value in profit-making terms is a real or actual value. Relying on its experts' testimony, petitioner argues that it is not "a real economic value".[29] We need not settle that dispute because, even were we to agree with respondent that value in profit-making terms is a real or actual value, that would not necessarily be determinative since our inquiry as to the predominant character of the windfall tax is not text bound. Indeed, however we describe the form of the

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[29] Mr. Osborne, one of petitioner's expert witnesses and a member of the Andersen team involved in designing the windfall tax, testified that value in profit-making terms "is not a real value: it is rather a construct based on realised profits that would not have been known at the date of privatisation, and a mechanism by which additional taxes on profits could be levied."

windfall tax base, our inquiry as to the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits. As an initial matter, we note that the parties have stipulated that none of the 31 companies that paid windfall tax had a windfall tax liability in excess of its total profits over its initial period.

With respect to design, respondent reorders the usual notion (at least in architecture) that form follows function to argue, in essence, that form determines function; i.e., that the design of the tax base (the excess of one value over another) demonstrates Parliament's decision to enact a tax based on value (i.e., "to tax undervaluation on flotation of the Windfall Tax Companies") "rather than a tax based on income or excess profits." We disagree.

Gordon Brown's public statements in his July 2, 1997, Budget Speech, the Inland Revenue and U.K. Treasury announcements, and the debate in Parliament preceding enactment of the windfall tax make clear that the tax was justified for two essentially equivalent reasons: (1) It would recoup excessive profits earned by the privatized utilities during the initial period, and (2) it would correct for the undervaluation of those companies at flotation. The reasons are equivalent because each subsumes the other. That is the essence of the explanation of the windfall tax by Her Majesty's Treasury in its 1997 publication entitled "Explanatory Notes: Summer Finance Bill 1997":

> The profits made by these companies in the years following privatisation were

> excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.

Thus, profits were considered excessive in relation to the prices at which the windfall tax companies were sold to the public, which, in turn, were deemed to be *too* low.[30] One explanation implies the other. It follows, then, that both parties may be said to be correct in their assessment of the political motivation for the windfall tax.

Of greater significance, in terms of the creditability of the windfall tax, is the fact that the members of Parliament understood that they were enacting a tax that, by its terms, represented one of two equivalent explanations. That understanding is evidenced by the Conservative Party Shadow Chancellor of the Exchequer's, Mr. Lilley's, recognition that the Government had "taken average profits over four years after flotation" and "[i]f those profits exceed one ninth of the flotation value, the

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[30] That rather obvious point was also made by Mr. Osborne:

> The rationale for the tax was rooted in * * * [the] initial period during which excessive profits were made, as judged against the companies' flotation values.
>
> The nature of the judgment means that there is a logical symmetry between the two available ways of describing the rationale for the tax — that profits were high in relation to the flotation value, or that the flotation value was low in relation to profits.* * *

company will pay windfall tax on the excess." Mr. Lilly's understanding that the windfall tax could be characterized as a tax on excess profits is further indicated by his recognition that privatized utilities "that failed to improve their profitability over * * * [the initial period] will pay much less or even no windfall tax."

Just as "a levy can in reality be directed at net gain even though it is imposed squarely on gross income", Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519, so too can a foreign levy be directed at net gain or income even through it is, by its terms, imposed squarely on the difference between two values.[31] And that is what we conclude in the case of

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[31] A classic definition of income from the economic literature is squarely so based: "Income is the money value of the net accretion to one's economic power between two points of time." Haig, "The Concept of Income–Economic and Legal Aspects", The Federal Income Tax 7 (Columbia University Press 1921).

Robert M. Haig's definition was subsequently expressed by another economist, Henry C. Simons, in a way that explicitly included consumption: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in questions." Simons, Personal Income Taxation 50 (1938). The Simons refinement has come to be known as the Haig-Simons definition of income and is widely accepted by lawyers and economists. Graetz & Schenk, Federal Income Taxation, Principles and Policies 97 (6th ed. 2009).

A foreign tax imposed on a base conforming to the Haig-Simons definition of income, viz, (1) the value of savings at the end of the period plus consumption during the period minus (2) the value of savings at the beginning of the period, would

the windfall tax. The architects and drafters of the tax knew (1) exactly which companies the tax would target, (2) the publicly reported after-tax financial profits of those companies, which were a crucial component of the tax base,[32] and (3) the target amount of revenue the tax would raise. Therefore, it cannot have been an unintentional or fortuitous result that, (1) for 29 of the 31 windfall tax companies that paid tax, the effective rate of tax on deemed annual excess profits was at or near 51.7 percent,[33] and (2) for none of the 31 companies did

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seem to qualify as a tax on net gain under the 1983 regulations. That the tax base includes unrealized appreciation in property is no bar to such qualification. See sec. 1.901-2(b)(2)(i)(C), (iv) *Example (2)*, Income Tax Regs.

[32] SWEB's ability to reduce retroactively its reported profits for one of its initial period years appears to have been a solitary aberration among the windfall tax companies and does not detract from the general conclusion that the initial period financial profits of the windfall tax companies were known before enactment.

[33] Because it had an initial period of only 316 days, Railtrack presents the sole exception to the overall conclusion that the windfall tax, viewed as a tax on excess profits, affected the targeted companies in a reasonable manner. As noted *supra*, the effective tax rate on Railtrack's excess profits was 239.10 percent and the cumulative 4-year return on flotation value to be exceeded for there to be a tax was only 9.62 percent. It is clear, however, that neither the regulations nor the cases interpreting them require that the foreign tax mimic the U.S. income tax for all taxpayers to achieve creditability under sec. 901, only that it satisfy that standard "in the normal circumstances in which it applies". See sec. 1.901-2(a)(3)(i), Income Tax Regs. See also *Exxon Corp. v. Commissioner*, 113

the tax exceed total initial period profits. What respondent refers to as "petitioner's algebraic reformulations of the Windfall Tax statute" do not, as respondent argues, constitute an impermissible "hypothetical rewrite of the Windfall Tax statute". Rather they represent a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies.[34] The design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it.[35]

T.C. at 352, in which we noted the Commissioner's acknowledgment that, "to qualify as an income tax a tax must satisfy the predominant character test in its application to a substantial number of taxpayers." In that case we found that the U.K. Petroleum Revenue Tax (PRT) provided a sufficient allowance in lieu of a deduction for interest expense where, for the 34 companies responsible for 91 percent of the PRT payments, the allowance exceeded nonallowed interest expense.

[34] Respondent describes petitioner's algebraic reformulation of the windfall tax as an attempt "to rewrite the value-based Windfall Tax to convert it into a profit-based tax." Presumably, respondent would agree that, had the tax been enacted as a "profit-based tax" instead of as a tax on the difference between two values, it would have been creditable. Under that approach, the same tax is either creditable or noncreditable, depending on the form in which it is enacted, a result at odds with the predominant character standard set forth in the regulations and applied in the caselaw.

[35] If, as respondent suggests, the real goal of the windfall tax was to recoup, on behalf of the public, the windfall to the initial investors that arose by virtue of flotation prices well below actual value (as perceived with hindsight), why did the Labour

Because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies, we find that it did, in fact, "reach net gain in the normal circumstances in which it [applied]", and, therefore, that its "predominant character" was "that of an income tax in the U.S. sense." See sec. 1.901-2(a)(1), (3), Income Tax Regs.

We recognize that, in the cases that have either provided the foundation for the predominant character standard (e.g., *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982), and Bank of America I), or applied that standard (e.g., Texasgulf I, Texasgulf II, and *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999)), the tax base, pursuant to the statute, was a gross amount or a gross amount less expenses comprising, in part, allowances in lieu of actual costs or expenses, and

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Party majority not try to recoup the entire windfall or at least a substantial portion of it; i.e., why was the tax rate not 100 percent or something closer to it than the 23-percent rate actually imposed? Although there is no evidence in the record that would provide a direct answer to that question, we find the enactment of the relatively low 23-percent rate to be consistent with an awareness of the Labour Party that it was taxing the companies, not the investors who actually benefited from the allegedly low flotation prices, and a decision, on its part, that a tax on the companies, being, in effect, a second tax on their initial period profits, should be imposed at a reasonable, nonconfiscatory rate, which would be sufficient to raise the desired revenue. That view is, of course, consistent with petitioner's argument that the form of the tax was adopted for "presentational" reasons.

the issue was whether the statutory tax base represented net gain for the majority of taxpayers subject to the foreign tax. Nevertheless, the analysis that led the courts in those cases (with the exception of *Inland Steel*)[36] to determine creditability or noncreditability of the foreign tax in issue is equally applicable in determining the creditability of the windfall tax, the question being whether, according to an empirical or quantitative analysis, the tax was likely reach net gain in the normal circumstances in which it applied. Because the facts of this case provide an affirmative answer to that question, we find the windfall tax to be creditable.

D. Conclusion

The windfall tax paid by petitioner's indirect U.K. subsidiary, SWEB, constituted an excess profits tax creditable under section 901.

II. The Dividend Rescission Issue

The parties submitted the dividend rescission issue fully stipulated. On brief, petitioner states that, if we resolve the windfall tax issue in its favor, then petitioner concedes the dividend rescission issue. Because we have done so, we need not address

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[36] As we noted in Texasgulf I, 107 T.C. at 71, the Court of Claims in *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982) "did not have industry-wide data to consider, and the Secretary had not yet promulgated regulations using a quantitative approach", and it held the Ontario Mining Tax to be noncreditable because it was not the "substantial equivalent" of an income tax, a standard for creditability that was modified by the 1983 regulations' adoption of the predominant character standard.

the dividend rescission issue. We accept petitioner's concession.[37]

III. Conclusion

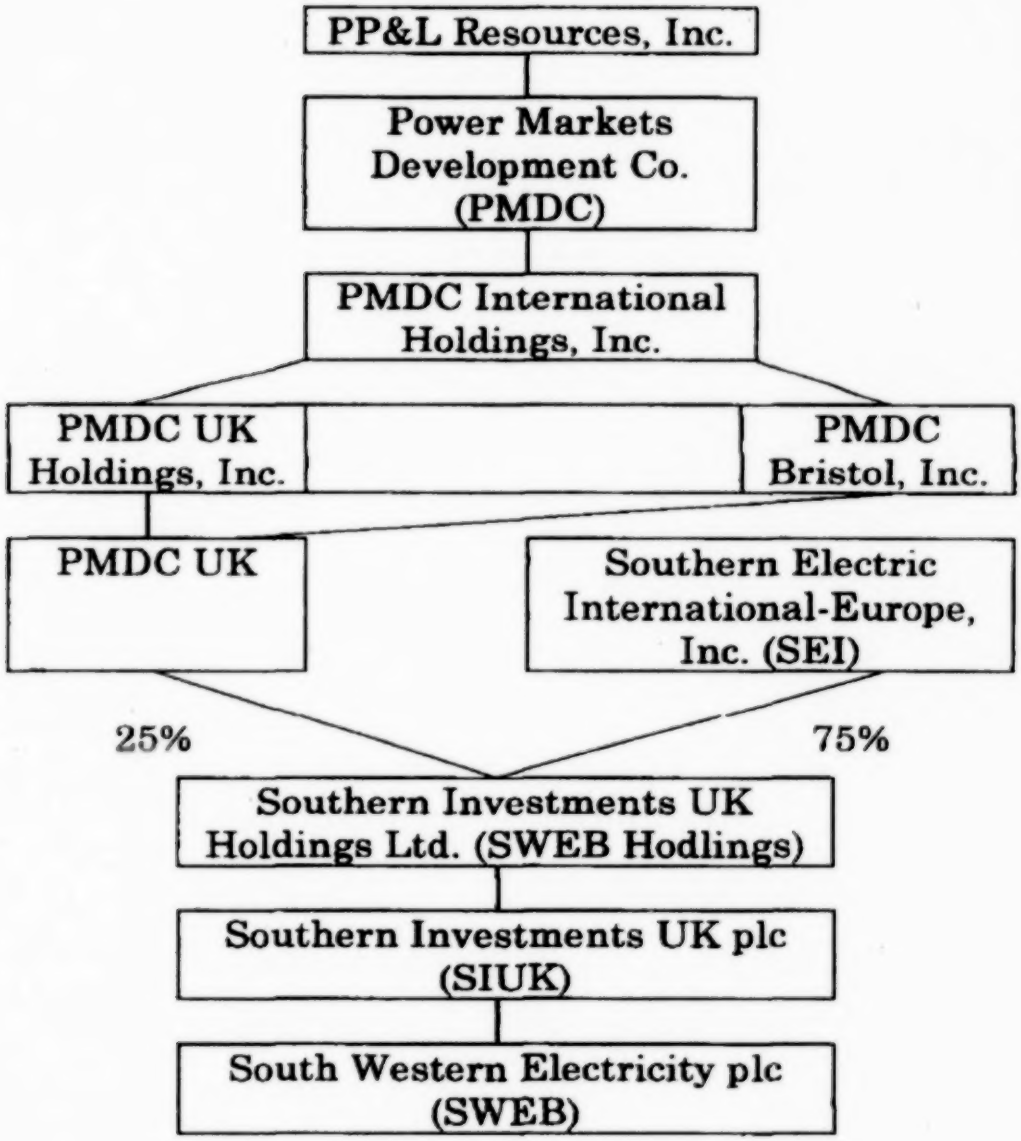
Taking into account our prior Opinion in *PPL Corp. & Subs. v. Commissioner*, 135 T.C. ___ (2010),

Decision will be entered under Rule 155.

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[37] Petitioner argues that if we resolve the windfall tax issue in its favor, then SWEB Holdings would not have had sufficient earnings and profits to pay a taxable dividend. Any distribution by SWEB Holdings would thus constitute a nontaxable return of capital. On brief, petitioner states that the "tax consequences [of such a nontaxable return of capital] would not, in petitioner's judgment, be material." For that reason, "[i]n the interest of judicial economy", petitioner does not ask that we decide the dividend rescission issue in its favor if we decide the windfall tax issue in its favor.

APPENDIX


PP&L Resources, Inc.
Power Markets Development Co. (PMDC)
PMDC International Holdings, Inc.
PMDC UK Holdings, Inc.
PMDC Bristol, Inc.
PMDC UK
Southern Electric International-Europe, Inc. (SEI)
25%
75%
Southern Investments UK Holdings Ltd. (SWEB Hodlings)
Southern Investments UK plc (SIUK)
South Western Electricity plc (SWEB)

Appendix F

26 U.S.C. § 901

Taxes of foreign countries and of possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) Resident of the United States or Puerto Rico

In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) Alien resident of the United States or Puerto Rico

In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and

(4) Nonresident alien individuals and foreign corporations

In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and

(5) Partnerships and estates

In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the

case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

(c) Similar credit required for certain alien residents

Whenever the President finds that—

(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country, the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign

country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of dividends from a DISC or former DISC

For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992(a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign taxes on mineral income

(1) Reduction in amount allowed

Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which—

(A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds

(B) the amount of the tax computed under this chapter with respect to such income.

(2) Foreign mineral income defined

For purposes of paragraph (1), the term "foreign mineral income" means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to—

(A) dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and

(B) that portion of the taxpayer's distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain payments for oil or gas not considered as taxes

Notwithstanding subsection (b) and sections 902 and 960, the amount of any income, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275(a) and this section if—

(1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies, and

(2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain taxes paid with respect to distributions from possessions corporations

(1) In general

For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation—

(A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

(B)(i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

(ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized, shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.

(2) Possessions corporation

For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during

which section 931 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) applied to such corporation, or during which section 957(c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) applied to such corporation.

[(h) Repealed. Pub. L. 110-172, § 11(g)(9), Dec. 29, 2007, 121 Stat. 2490]

(i) Taxes used to provide subsidies

Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent—

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

(j) Denial of foreign tax credit, etc., with respect to certain foreign countries

(1) In general

Notwithstanding any other provision of this part—

(A) no credit shall be allowed under subsection (a) for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under section 902 or 960) to

any country if such taxes are with respect to income attributable to a period during which this subsection applies to such country, and

(B) subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country.

(2) Countries to which subsection applies

(A) In general

This subsection shall apply to any foreign country—

(i) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,

(ii) with respect to which the United States has severed diplomatic relations,

(iii) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or

(iv) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorisms.

(B) Period for which subsection applies

This subsection shall apply to any foreign country described in subparagraph (A) during the period—

(i) beginning on the later of—

(I) January 1, 1987, or

(II) 6 months after such country becomes a country described in subparagraph (A), and

(ii) ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer described in subparagraph (A).

(3) Taxes allowed as a deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(4) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations which treat income paid through 1 or more entities as derived from a foreign country to which this subsection applies if such income was, without regard to such entities, derived from such country.

(5) Waiver of denial

(A) In general

Paragraph (1) shall not apply with respect to taxes paid or accrued to a country if the President—

(i) determines that a waiver of the application of such paragraph is in the national interest of the United States and will expand trade and investment opportunities for United States companies in such country; and

(ii) reports such waiver under subparagraph (B).

(B) Report

Not less than 30 days before the date on which a waiver is granted under this paragraph, the President shall report to Congress—

(i) the intention to grant such waiver; and

(ii) the reason for the determination under subparagraph (A)(i).

(k) Minimum holding period for certain taxes on dividends

(1) Withholding taxes

(A) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax

on a dividend with respect to stock in a corporation if—

(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(B) Withholding tax

For purposes of this paragraph, the term "withholding tax" includes any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

(2) Deemed paid taxes

In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if—

(A) any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

(B) the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

(3) 45-day rule in the case of certain preference dividends

In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied—

(A) by substituting "45 days" for "15 days" each place it appears, and

(B) by substituting "91-day period" for "31-day period".

(4) Exception for certain taxes paid by securities dealers

(A) In general

Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a business as a securities dealer of any person—

(i) who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

(ii) who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or (iii) who is licensed or authorized in such foreign country to conduct securities activities in such country and is subject to bona fide regulation by a

securities regulating authority of such country.

(B) Qualified tax

For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(5) Certain rules to apply

For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246(c) shall apply.

(6) Treatment of bona fide sales

If a person's holding period is reduced by reason of the application of the rules of section 246(c)(4) to any contract for the bona fide sale of stock, the determination of whether such

person's holding period meets the requirements of paragraph (2) with respect to taxes deemed paid under section 902 or 960 shall be made as of the date such contract is entered into.

(7) Taxes allowed as deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(*l*) Minimum holding period for withholding taxes on gain and income other than dividends etc.

(1) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if—

(A) such property is held by the recipient of the item for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

(2) Exception for taxes paid by dealers

(A) In general

Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

(B) Qualified tax

For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Dealer

For purposes of subparagraph (A), the term "dealer" means—

(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof, and

(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

(D) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(3) Exceptions

The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

(4) Certain rules to apply

Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

(5) Determination of holding period

Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule.

(m) Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions

(1) In general

In the case of a covered asset acquisition, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets—

(A) shall not be taken into account in determining the credit allowed under subsection (a), and

(B) in the case of a foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), shall not be taken into account for purposes of section 902 or 960.

(2) Covered asset acquisition

For purposes of this section, the term "covered asset acquisition" means—

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which—

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

(D) to the extent provided by the Secretary, any other similar transaction.

(3) Disqualified portion

For purposes of this section—

(A) In general

The term "disqualified portion" means, with respect to any covered asset acquisition, for any taxable year, the ratio (expressed as a percentage) of—

(i) the aggregate basis differences (but not below zero) allocable to such taxable year under subparagraph (B) with respect to all relevant foreign assets, divided by

(ii) the income on which the foreign income tax referred to in paragraph (1) is determined (or, if the taxpayer fails to substantiate such income to the satisfaction of the Secretary, such income shall be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction).

(B) Allocation of basis difference

For purposes of subparagraph (A)(i)—

(i) In general

The basis difference with respect to any relevant foreign asset shall be allocated to taxable years using the applicable cost recovery method under this chapter.

(ii) Special rule for disposition of assets

Except as otherwise provided by the Secretary, in the case of the disposition of any relevant foreign asset—

(I) the basis difference allocated to the taxable year which includes the date of such disposition shall be the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset which has been allocated under clause (i) to all prior taxable years, and

(II) no basis difference with respect to such asset shall be allocated under clause (i) to any taxable year thereafter.

(C) Basis difference

(i) In general

The term "basis difference" means, with respect to any relevant foreign asset, the excess of—

(I) the adjusted basis of such asset immediately after the covered asset acquisition, over

(II) the adjusted basis of such asset immediately before the covered asset acquisition

(ii) Built-in loss assets

In the case of a relevant foreign asset with respect to which the amount described in clause (i)(II) exceeds the amount described in clause (i)(I), such excess shall be taken into account under this subsection as a basis difference of a negative amount.

(iii) Special rule for section 338 elections

In the case of a covered asset acquisition described in paragraph (2)(A), the covered asset acquisition shall be treated for purposes of this subparagraph as occurring at the close of the acquisition date (as defined in section 338(h)(2)).

(4) Relevant foreign assets

For purposes of this section, the term "relevant foreign asset" means, with respect to any covered asset acquisition, any asset (including any goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the foreign income tax referred to in paragraph (1).

(5) Foreign income tax

For purposes of this section, the term "foreign income tax" means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States.

(6) Taxes allowed as a deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(7) Regulations

The Secretary may issue such regulations or other guidance as is necessary

or appropriate to carry out the purposes of this subsection, including to exempt from the application of this subsection certain covered asset acquisitions, and relevant foreign assets with respect to which the basis difference is de minimis.

(n) Cross reference

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2) For right of each partner to make election under this section, see section 703(b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a).

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation or partnership controlled by him, see section 6038.

Treas. Reg. § 1.901-2

(a) Definition of income, war profits, or excess profits tax—(1) In general. Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section and §§ 1.901-2A and 1.903-1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if—

(i) It is a tax; and

(ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms "paid by," "foreign country," and "foreign levy." Paragraph (h) of this section states the effective date of this section.

(2) Tax—(i) In general. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes.

A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign

levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901-2A.

(ii) Dual capacity taxpayers—(A) In general. For purposes of this section and §§ 1.901-2A and 1.903-1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a "dual capacity taxpayer." Dual capacity taxpayers are subject to the special rules of § 1.901-2A.

(B) Specific economic benefit. For purposes of this section and §§ 1.901-2A and 1.903-1, the term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned

petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) Pension, unemployment, and disability fund payments. A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) Control of property. A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of

property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) Indirect receipt of a benefit. A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person—

(1) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(2) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) Predominant character. The predominant character of a foreign tax is that of an income tax in the U.S. sense—

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) Net gain—(1) In general. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) Realization—(i) In general. A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—

(A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available

against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and—

(1) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(2) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement

even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) Certain deemed distributions. A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.*, by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.*, an actual distribution), impose tax ("second tax") with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(iii) Readily marketable property. Property is readily marketable if—

> (A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale

to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iv) Examples. The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example 1. Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows: A, a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, A pays 2u for 1983 (10 percent of (120u–100u)), 3.5u for 1984 (10 percent of (155u–120u)), and nothing in 1985 because no stock was held at the end of that year. For purposes of the income tax, A must include 60u (160u–100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the

realization requirement because country X imposes a second tax upon the occurrence of a later event (*i.e.*, the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

Example 2. The facts are the same as in example 1 except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, A includes only 5u (160u–155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example 3. Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is

imposed subsequent to the occurrence of events that would result in realization of income (*i.e.*, by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization requirement.

Example 4. Country X imposes a tax on the realized net income of corporations that do business in country X (the "country X corporate tax"). Country X also imposes a separate tax on shareholders of such corporations (the "country X shareholder tax"). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (*i.e.*, income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(3) Gross receipts—(i) In general. A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) Examples. The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example 1. Country X imposes a "headquarters company tax" on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters

company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example 2. The facts are the same as in Example 1, with the added fact that in the case of a particular taxpayer, A, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example 1 for all persons subject to the headquarters company tax, including A.

Example 3. Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts requirement. However, if the tax satisfies the criteria of § 1.903-1(a), it is a tax in lieu of an income tax.

(4) Net income—(i) In general. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit—

(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or

(B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax

system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement,

it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) Consolidation of profits and losses. In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (*e.g.*, a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (*e.g.*, a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (*e.g.*, oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e.g.*, oil and gas

refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) Carryovers. In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) Examples. The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example 1. Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses

(e.g., interest expense) attributable to their interest income. The bank tax neither provides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example 2. Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example 1, the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax

satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example 3. A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain. Accordingly, the tax satisfies the net income requirement.

Example 4. Country X imposes a tax at the rate of 48 percent of the "taxable income" of nonresidents of country X who furnish specified types of services to customers who are residents of country X. "Taxable income" for purposes of the tax is defined as gross receipts received from residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisfies the net income requirement.

Example 5. Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the "country X income tax" and

the "province Y income tax," respectively. Each tax has an identical base, which is computed by reducing a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

* * *

Finance (No. 2) Act, 1997, c. 58 (U.K.)

An Act to grant certain duties, to alter other duties, and to amend the law relating to the National Debt and the Public Revenue, and to make further provision in connection with Finance.

[31st July 1997]

Most Gracious Sovereign,

WE, Your Majesty's most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, towards raising the necessary supplies to defray Your Majesty's public expenses, and making an addition to the public revenue, have freely and voluntarily resolved to give and grant unto Your Majesty the several duties hereinafter mentioned; and do therefore most humbly beseech Your Majesty that it may be enacted, and be it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

PART I

THE WINDFALL TAX

1.—Charge to windfall tax.

(1) Every company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation shall be charged with a tax (to be known as the "windfall tax") on the amount of that windfall.

(2) Windfall tax shall be charged at the rate of 23 per cent.

(3) Schedule 1 to this Act (which sets out how to quantify the windfall from which a company was benefitting on 2nd July 1997) shall have effect.

2.—The companies benefitting from windfalls.

(1)For the purposes of this Part a company in existence on 2nd July 1997 was benefitting on that date from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation if—

(a) that company, or a company of which it was on that date a demerged successor, had before that date been privatised by means of a flotation;

(b) there had, before that flotation, been a statutory transfer of property, rights and liabilities from a public corporation to the floated company or to a company which, at the time of the flotation, was a subsidiary undertaking of the floated company; and

(c) at the time of the flotation, the floated company was carrying on an undertaking whose privatisation involved the imposition of economic regulation.

(2) For the purposes of this Part a company was privatised by means of a flotation if—

(a) an offer of shares in that company was at any time made to the public in the United Kingdom;

(b) the shares which were the subject-matter of the offer were publicly-owned at the time of the offer;

(c) the offer was or included an offer of shares for disposal at a fixed price; and

(d) shares in that company were first admitted to listing on the Official List of the Stock Exchange in pursuance of an application made in connection with the offer.

(3) In this Part references, in relation to a company privatised by means of a flotation, to the time of the company's flotation are references to the time when shares in the floated company were first admitted to listing on the Official List of the Stock Exchange.

(4) For the purposes of this Part a company in existence on 2nd July 1997 ("the relevant company") was on that date a demerged successor of a company privatised by means of a flotation if—

(a) after the flotation of the floated company but before 2nd July 1997, there had been a statutory transfer of property, rights and liabilities from the floated company to a company ("the transferee company") which was a subsidiary undertaking of the floated company at the time of the transfer;

(b) the transferee company was not a subsidiary undertaking of the floated company on 2nd July 1997 but was, on that date, a subsidiary undertaking of the relevant company; and

(c) before 2nd July 1997 shares in the relevant company had been admitted to listing on the

Official List of the Stock Exchange in pursuance of an application made in connection with the transaction, or series of transactions, by virtue of which the transferee company ceased to be a subsidiary undertaking of the floated company.

(5) For the purposes of this section a company was, at the time of its flotation, carrying on an undertaking whose privatisation involved the imposition of economic regulation if that company, or a company which at that time was a subsidiary undertaking of that company, was at that time—

(a) a public telecommunications operator, within the meaning of the [M1]Telecommunications Act 1984;

(b) an airport operator in relation to an airport subject to economic regulation under Part IV of the [M2]Airports Act 1986;

(c) the holder of an authorisation granted under section 7 of the [M3]Gas Act 1986, as originally enacted (public gas suppliers);

(d) the holder of an appointment under section 11 of the [M4]Water Act 1989 as the water undertaker for any area of England and Wales;

[M1] 1984 c.12.

[M2] 1986 c.31.

[M3] 1986 c.44.

[M4] 1989 c.15.

(e) the holder of a licence granted under section 6 of the [M5]Electricity Act 1989 or Article 10 of the [M6]Electricity (Northern Ireland) Order 1992 (licences authorising generation, transmission and supply of electricity); or

(f) a company authorised by a licence under section 8 of the [M7]Railways Act 1993 to be the operator of a railway asset.

(6) In subsection (5) above "airport operator" has the [M8]same meaning as in the Airports Act 1986.

3.—Administration of the windfall tax etc.

(1) The windfall tax shall be under the care and management of the Commissioners of Inland Revenue.

(2) Schedule 2 to this Act (which makes provision with respect to the management and collection of the windfall tax) shall have effect.

(3) Subject to paragraph 19(5) of Schedule 8 to the Taxes Act 1988 (which is the provision about profit-related pay schemes that is amended by section 4 below), nothing in this Act or the Tax Acts shall have the effect of allowing or requiring any amount of windfall tax to be deducted in computing

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[M5] 1989 c. 29.

[M6] S.I. 1992/231 (N.I. 1).

[M7] 1993 c. 43.

[M8] 1986 c. 31.

income, profits or losses for any of the purposes of the Tax Acts.

4.—The windfall tax and profit-related pay.

(1) In paragraph 19 of Schedule 8 to the Taxes Act 1988 (ascertainment of profits for the purposes of profit-related pay schemes)—

(a) in sub-paragraph (5)(b), after "1985" there shall be inserted "or section 3(3) of the Finance (No. 2) Act 1997"; and

(b) after paragraph (ff) of sub-paragraph (6) there shall be inserted the following paragraph—

"(fg) windfall tax charged under Part I of the Finance (No. 2) Act 1997;".

(2) Subsection (1) above has effect in relation to the preparation, for the purposes of any scheme, of a profit and loss account for any period ending on or after 2nd July 1997.

(3) Subsection (1) above shall not have effect in relation to an existing scheme unless, before the end of the period of six months beginning with the day on which this Act is passed, the scheme is altered, with effect for all periods ending on or after 2nd July 1997, to take account of that subsection.

(4) Provision made, in compliance with paragraph 20(1) of Schedule 8 to the Taxes Act 1988 (consistency in preparation of accounts), by any existing scheme that is altered to take account of subsection (1) above shall not prevent a profit and loss account from being prepared in accordance with the alteration.

(5) An alteration of an existing scheme to take account of subsection (1) above shall be treated as being within section 177B of the Taxes Act 1988 (alterations which are registrable and which, when registered, cannot give rise to the Board's power of cancellation).

(6) In this section "existing scheme" means a scheme which at any time in the period beginning with 2nd July 1997 and ending immediately before the day on which this Act is passed was a registered scheme under Chapter III of Part V of the Taxes Act 1988.

(7) The preceding provisions of this section shall cease to have effect, in accordance with the notes to Part VI(3) of Schedule 18 to the [M9]Finance Act 1997, as if they were included in the repeal of Schedule 8 to the Taxes Act 1988.

5.—Interpretation of Part I

(1) In this Part—

"company" means a company within the meaning of the [M10]Companies Act 1985 or the [M11]Companies (Northern Ireland) Order 1986;

"fixed price", in relation to any offer of publicly-owned shares in a company, means—

(a) a price set out in the offer; or

[M9] 1997 c.16.

[M10] 1985 c. 6.

[M11] S.I. 1986/1032 (N.I. 6).

(b) a price subsequently fixed by a Minister of the Crown in a case in which the amount of a first instalment of the price was fixed by the offer;

"the floated company", in relation to the privatisation of a company by means of a flotation, means the company so privatised;

"public corporation", in relation to a statutory transfer, means any body corporate in existence at the time of the transfer which—

(a) had been established by or in accordance with the provisions of any enactment; and

(b) had a membership consisting of, or including, persons appointed as members by a Minister of the Crown;

"publicly-owned", in relation to any shares, means held by—

(a) a Minister of the Crown or the Treasury; or

(b) a nominee for a Minister of the Crown or for the Treasury;

"share" includes any right to require the issue of a share;

"statutory transfer" means a transfer under a transferring enactment or by or in accordance with a statutory scheme;

"subsidiary undertaking"—

(a) except in relation to a company formed and registered in Northern Ireland, means a subsidiary undertaking within the meaning of Part VII of the Companies Act 1985; and

(b) in relation to a company so formed and registered, means a subsidiary undertaking within the meaning of Part VIII of the Companies (Northern Ireland) Order 1986.

(2) In this section—

"enactment" means an enactment contained in a public general Act or any provision of Northern Ireland legislation;

"Minister of the Crown" includes a Northern Ireland department or the head of such a department;

"statutory scheme" means any scheme which—

(a) has been made in exercise of any power or duty conferred or imposed by any enactment;

(b) contains provision for the division of property, rights and liabilities between different persons, or for the transfer of property, rights and liabilities to a company; and

(c) would not have taken effect or come into force but for having been approved by a Minister of the Crown;

"transferring enactment" means an enactment under which property, rights and liabilities of a person specified in the enactment became, by virtue of that enactment, the property, rights or liabilities of a company nominated under that enactment.

(3) In subsection (2) above the reference, in relation to a scheme, to its having been approved by a Minister of the Crown includes a reference to its having been made by a Minister of the Crown.

(4) The reference in subsection (1) above to Part VII of the [M12]Companies Act 1985 shall be construed, in relation to times in relation to which that Part had effect without the amendments made by the [M13]Companies Act 1989, as if those amendments did have effect in relation to those times.

* * *

SCHEDULE 1

Section 1.

QUANTIFICATION OF A PRIVATISATION WINDFALL

The basic rule

1 (1) Subject to paragraph 7 below, where a company was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation, the amount of that windfall shall be taken for the purposes of this Part to be the excess (if any) of the amount specified in sub- paragraph (2)(a) below over the amount specified in sub-paragraph (2)(b) below.

(2) Those amounts are the following amounts (determined in accordance with paragraphs 2 to 6 below), that is to say—

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and

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[M12] 1985 c. 6.

[M13] 1989 c. 40.

(b) the value which for privatisation purposes was put on that disposal.

Value of a disposal in profit-making terms

2 (1) Subject to paragraph 4 below, the value in profit-making terms of the disposal made on the occasion of a company's flotation is the amount produced by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio.

(2) For the purposes of this paragraph the average annual profit for a company's initial period is the amount produced by the following formula—

$A = 365 \times P/D$

Where—

A is the average annual profit for the company's initial period;

P is the amount, ascertained in accordance with paragraph 5 below, of the total profits for the company's initial period; and

D is the number of days in the company's initial period.

(3) For the purposes of this paragraph the applicable price-to-earnings ratio is 9.

Value put on a disposal for privatisation purposes

3 (1) Subject to paragraph 4 below, the value which for privatisation purposes was put on the disposal made on the occasion of a company's flotation is the amount produced by multiplying the institutional price by the number of shares

comprised in the ordinary share capital of the company at the time of its flotation.

(2) In this paragraph "the institutional price", in relation to a company, means the highest fixed price per share at which publicly-owned shares in the company were offered for disposal on the occasion of the company's flotation.

(3) Subject to sub-paragraph (4) below, where publicly-owned shares in a company were offered for disposal in accordance with any arrangements for the payment of the price in two or more instalments, the price per share at which those shares were offered shall be ascertained by aggregating the instalments.

(4) Where the arrangements under which any publicly-owned shares in a company were offered for disposal provided for any discount on the payment of the whole or any part of the price for those shares, that discount shall be disregarded for the purposes of this paragraph in determining the price per share at which those shares were offered.

Cases where company privatised in stages

4 (1) For the purposes of this Schedule, where the disposal percentage in the case of any company was 85 per cent. or less—

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation, and

(b) the value which for privatisation purposes was put on that disposal, shall each be taken to be the disposal percentage of the amount which,

under paragraph 2 or 3 above, would be the amount of that value but for this paragraph.

(2) For the purposes of this paragraph "the disposal percentage", in relation to any company, means the percentage which expresses (in terms of nominal value) how much of the ordinary share capital of the company at the time of its flotation was represented by the publicly-owned shares in the company offered for disposal on the occasion of the company's flotation.

Total profits for the initial period

5 (1) For the purposes of paragraph 2 above the amount of the total profits for a company's initial period is the sum of the amounts falling within sub-paragraph (2) below.

(2) Subject to sub-paragraph (3) and paragraph 6(3) below, those amounts are every amount which, for a financial year of the company ending in or at the end of its initial period, is shown in the relevant accounts for that year—

(a) where those accounts are prepared in accordance with section 227 of the [M46]Companies Act 1985 (group accounts), as the profit of that company and its subsidiary undertakings for that year; and

(b) in any other case, as the profit of that company for that year.

(3) Where—

[M46] 1985 c. 6.

(a) any profit shown in the relevant accounts of a company for any financial year has been computed using a current cost accounting method, but

(b) the information which was contained in those accounts, or which was provided to the registrar together with those accounts, included information from which it can be ascertained what that profit would have been if an historical cost accounting method had been used,

the amount shown as that profit in those accounts shall be deemed to be the amount (as ascertained from that information) which would have been so shown if that historical cost accounting method had been used.

(4) In this paragraph references, in relation to any financial year of a company, to the relevant accounts are references to any such accounts for that year as have been or are delivered to the registrar under section 242 of the Companies Act 1985 and consist—

(a) in the case of a financial year at the end of which the company was a parent undertaking, in consolidated group accounts prepared in accordance with section 227 of that Act (group accounts); and

(b) in any other case, in accounts prepared in accordance with section 226 of that Act (individual accounts).

(5) Subject to sub-paragraph (6) below, references in this paragraph to the amount shown in any accounts as the profit for any financial year are

references to the amount of the profit (if any) for that year which is set out in the profit and loss account comprised in those accounts as the item which is, or is the equivalent of, the final item of the statutory format which for that year was used for that profit and loss account.

(6) Where any amount shown in any accounts is less than it would have been if no provision or other deduction had been made—

(a) in relation to the windfall tax, or

(b) in anticipation of the imposition of a charge with characteristics similar to those of the windfall tax,

this Schedule shall have effect as if the amount shown were the amount it would have been if that provision or deduction had not been made.

(7) Nothing in this paragraph shall, in the case of any company—

(a) prevent any charge to windfall tax from being treated as having arisen on 2nd July 1997 by reference to accounts delivered to the registrar after that date; or

(b) prevent any requirement to pay an instalment of windfall tax, or any other liability under Schedule 2 to this Act, from arising before the delivery to the registrar of the accounts by reference to which the amount of that charge is computed;

and any power of the Board under that Schedule to make an assessment shall include power to make an assessment on the basis that accounts will be

delivered to the registrar showing such amounts as may, to the best of their judgement, be determined by the Board.

(8) Subject to sub-paragraph (9) below, this paragraph shall have effect in relation to anytime at which the [M47]Companies Act 1985 had effect without the amendments made by the [M48]Companies Act 1989—

(a) as if the references in sub-paragraphs (2) and (4) above to sections 226, 227 and 242 of the Companies Act 1985 were references, respectively, to sections 227, 229 and 241 of that Act, as it had effect without those amendments;

(b) as if the reference in sub-paragraph (2) above to a company's subsidiary undertakings were a reference to its subsidiaries (within the meaning of that Act as it so had effect); and

(c) as if the reference in sub-paragraph (4)(a) above to a company's being a parent undertaking were a reference to its having such subsidiaries.

(9) In relation to a company formed and registered in Northern Ireland, this paragraph shall have effect as if the references in sub-paragraphs (2) and (4) above to sections 226, 227 and 242 of the Companies Act 1985 were references, respectively, to

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[M47] 1985 c. 6.

[M48] 1989 c. 40.

Articles 234, 235 and 250 of the [M49]Companies (Northern Ireland) Order 1986.

(10) In this paragraph—

"the registrar" means—

(a) except in relation to a company formed and registered in Northern Ireland, the registrar within the meaning of the Companies Act 1985; and

(b) in relation to a company so formed and registered, the registrar within the meaning of the Companies (Northern Ireland) Order 1986;

and

"statutory format", in relation to a profit and loss account, means a format set out in the provisions (as they had effect in relation to that account) of Schedule 4 to the Companies Act 1985 or Schedule 4 to the Companies (Northern Ireland) Order 1986.

Meaning of the initial period etc

6 (1) In this Schedule "initial period", in relation to a company privatised by means of a flotation, means (subject to sub-paragraph (2) below) the period which—

(a) begins with the first day of the first financial year of the company to begin after the time of its flotation; and

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[M49] S.I. 1986/1032 (N.I. 6).

(b) ends with the end of the fourth financial year of the company to begin after the time of its flotation.

(2) Where the initial period of a company privatised by means of a flotation would (but for this sub-paragraph) include any time on or after 1st April 1997, sub-paragraph (1) above shall not apply and the initial period of that company shall be taken, instead, to be the period which—

(a) begins with the day on which the time of its flotation falls; and

(b) ends with the end of the last financial year of the company to end before 1st April 1997.

(3) Where—

(a) sub-paragraph (2) above applies for determining a company's initial period, and

(b) there is a financial year of that company beginning before but ending after the beginning of that initial period,

the amount which for that year is shown as mentioned in paragraph 5(2) above shall be included in the sums added together for the purposes of paragraph 5(1) above to the extent only that that amount is attributable, on an apportionment made in accordance with the following provisions of this paragraph, to the part of that year falling within the company's initial period.

(4) Except in a case where sub-paragraph (5) below applies, an apportionment for the purposes of sub-paragraph (3) above shall be made on a time basis according to the respective lengths of—

(a) the part of the financial year falling before the beginning of the company's initial period; and

(b) the remainder of that financial year.

(5) Where the circumstances of a particular case are such that—

(a) the making of an apportionment on the basis mentioned in sub-paragraph (4) above would work in a manner that would be unjust or unreasonable, but

(b) it would be just and reasonable to make the apportionment on the alternative basis,

the apportionment shall be made, instead, on the alternative basis.

(6) For the purposes of this paragraph an apportionment in the case of any company of the amount shown for any financial year as a profit for that year is made on the alternative basis where it is made according to how much of that profit accrued in each of the two parts of that financial year that are mentioned in sub-paragraph (4) above.

Apportionment between demerged successors and predecessors

7 (1) This paragraph applies where—

(a) a company ("the predecessor company") was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation; and

(b) another company which on that date was a demerged successor of the predecessor company is also taken for the purposes of this Part to have been benefitting from such a windfall on that date.

(2) Where this paragraph applies—

(a) the amount of the windfall from which the predecessor company was benefitting on 2nd July 1997 shall be equal to only the appropriate fraction of the amount ("the total windfall") which (but for this paragraph) would have been the amount of that windfall under paragraphs 1 to 6 above; and

(b) the amount of the windfall from which the demerged successor shall be taken to have been benefitting on that date shall be equal to the remainder of the total windfall.

(3) In this paragraph "the appropriate fraction" means the following fraction—

P / P+S

Where—

P is the amount produced by multiplying the number of shares comprised at the end of the relevant day in the ordinary share capital of the predecessor company by the market price on that day of an ordinary share in that company; and

S is the amount produced by multiplying the number of shares comprised at the end of the relevant day in the ordinary share capital of the demerged successor by the market price on that

day of an ordinary share in the demerged successor.

(4) For the purposes of this paragraph references to the market price of shares on any day are references to the sum of—

(a) the lower of the two prices shown in the Stock Exchange Daily Official List for that day as the closing prices for the shares on that day; and

(b) one half of the difference between those two prices.

(5) In this paragraph "the relevant day" means the day on which shares in the demerged successor were first listed on the Official List of the Stock Exchange.

General interpretation of the Schedule

8 (1) In this Schedule "financial year", in relation to a company, means (subject to sub-paragraph (2) below)—

(a) a financial year of that company within the meaning of Part VII of the [M50]Companies Act 1985; or

(b) any period which—

(i) began before the coming into force of section 3 of the [M51]Companies Act 1989 (new definition of financial year); and

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[M50] 1985 c. 6.

[M51] 1989 c. 40.

(ii) was a financial year of that company for the purposes of that Part, as it had effect without the amendments made by that section.

(2) Sub-paragraph (1) above does not apply to a company formed and registered in Northern Ireland; and in relation to such a company, references in this Schedule to a financial year are references to a financial year within the meaning of Part VIII of the [M52]Companies (Northern Ireland) Order 1986.

(3) In this Schedule references, in relation to a company privatised by means of a flotation, to the shares offered for disposal on the occasion of the company's flotation are references to the following shares in that company, that is to say—

(a) those that were the subject-matter of the offer to the public in respect of which that company is regarded for the purposes of this Part as having been so privatised; and

(b) any publicly-owned shares not falling within paragraph (a) above that were the subject-matter of an offer for disposal made on the same occasion as the offer mentioned in that paragraph.

(4) References in this Schedule to an offer for the disposal of shares in a company include references to any offer to transfer or confer an immediate or contingent right to or interest in any such shares, whether or not for a consideration; and (subject to

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[M52] S.I. 1986/1032 (N.I. 6).

sub-paragraph (5) below) references to the shares that are the subject-matter of such an offer shall be construed accordingly.

(5) For the purposes of sub-paragraph (3) above where—

(a) an offer for the disposal of publicly-owned shares in a company contained provision for a person to become entitled to further shares in that company if he satisfied conditions specified in the offer, and

(b) those conditions included a condition as to the period for which shares in that company continued to be held by that person,

shares which (apart from this sub-paragraph) would fall to be treated as the subject-matter of the offer by virtue only of that provision shall be treated as the subject-matter of the offer to the extent only that persons did in fact become entitled to them before 2nd July 1997 as a result of having satisfied the conditions in question.

(6) In this Schedule a reference, in relation to any time, to the ordinary share capital of a company is a reference to the following, taken together, that is to say—

(a) the shares comprised in the ordinary share capital of the company (within the meaning of the Tax Acts); and

(b) any shares that would have been so comprised at that time if the issued share capital of the company at that time had included any shares in the company that had been allotted but not issued. * * *

OPPOSITION BRIEF

No. 12-43

In the Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether the "windfall tax" set forth in the United Kingdom's Finance (No. 2) Act, 1997, c. 58 (U.K.), which imposed on privatized utilities a one-time 23% tax on the difference between a company's profit-making value and its privatization value, is an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901.

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26 U.S.C. 901(a) 2
26 U.S.C. 901(b)(1) 2
26 U.S.C. 902 6
26 U.S.C. 2032A(e)(8) 10
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John A. Bogdanski, *Federal Tax Valuation* (2003) 10

In the Supreme Court of the United States

No. 12-43

PPL CORPORATION AND SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-15) is reported at 665 F.3d 60. The opinion of the United States Tax Court (Pet. App. 22-87) is reported at 135 T.C. 304.

JURISDICTION

The amended judgment of the court of appeals was entered on January 13, 2012 (Pet. App. 16-17). A petition for rehearing was denied on March 9, 2012 (Pet. App. 20-21). On May 10, 2012, Justice Alito extended the time within which to file a petition for a writ of certiorari to and including July 9, 2012, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 901 of the Internal Revenue Code allows a United States citizen or domestic corporation to claim a credit against its United States income tax liability for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. 901(a) and (b)(1). The goal of the foreign tax credit is to reduce double taxation of foreign-source income paid to U.S. taxpayers. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

In 1983, the Secretary of the Treasury issued a regulation that defines a creditable foreign tax under Section 901. See 26 C.F.R. 1.901-2. The regulation states that a foreign tax is creditable "if and only if * * * [t]he predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. 1.901-2(a)(1)(ii). That standard is met if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. 1.901-2(a)(3)(i).

The regulation explains that a foreign tax is likely to reach net gain "if and only if the tax, judged on the basis of its predominant character," satisfies each of three tests: the realization test, the gross-receipts test, and the net-income test. 26 C.F.R. 1.901-2(b)(1). The realization test is satisfied if the foreign tax "is imposed [u]pon or subsequent to the occurrence of events * * * that would result in the realization of income under the income tax provisions of the Internal Revenue Code." 26 C.F.R. 1.901-2(b)(2)(i)(A). The gross-receipts test is satisfied if the foreign tax is imposed on the basis of gross receipts or an equivalent thereof "computed under a method that is likely to produce an amount that is not greater than [the] fair market value." 26 C.F.R. 1.901-2(b)(3)(i). The net-income test is satisfied if "the base of

the tax is computed by reducing gross receipts * * * to permit * * * [r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." 26 C.F.R. 1.901-2(b)(4)(i)(A).

2. a. Between 1984 and 1996, the government of the United Kingdom, under the control of the Conservative Party, privatized ownership of more than 50 state-owned companies by "flotation" (*i.e.*, public offering) of their stock. C.A. J.A. 100-101, 108. The flotation process involved the transfer of the companies' assets to newly created "public limited companies," followed by the offering of the new companies' shares to the public at a fixed price. *Id.* at 100-101. In December 1990, the U.K. government privatized twelve regional electric companies, including South Western Electricity plc (SWEB), which later became a subsidiary of petitioner. *Id.* at 88-93, 101.

The U.K. Government regulated the prices that the privatized utilities could charge the public. Pet. App. 2; C.A. J.A. 846-848. Nevertheless, because the privatized utilities increased efficiency to a greater degree than had been expected when the initial price controls were established, the companies realized substantially higher profits than had been anticipated. Pet. App. 2-3; C.A. J.A. 854-858. It was thus widely believed in the U.K. that the utilities had been sold too cheaply and that their profits were excessive in relation to their flotation value. *Id.* at 268, 1194-1195, 1339.

b. In 1996, the Labour Party began to explore the possibility of imposing a "windfall tax" on the privatized utilities, which it promised to enact if restored to power. C.A. J.A. 103-104. Geoffrey Robinson, a member of Parliament and the Labour Party's Paymaster General,

hired Arthur Andersen to assist the Labour Party's shadow treasury team in developing a proposal for the tax. *Id.* at 104.

The Andersen team considered three "simple" and three "complex" solutions for structuring the tax. The three simple solutions were to tax gross receipts, assets, or profits. The three complex solutions were to tax excess profits, excess shareholder returns, or a "windfall" amount. C.A. J.A. 36-43, 1107-1108. The team rejected all three simple solutions and the first two complex solutions. Robinson and the Anderson team settled on a one-time tax that would be charged on the "windfall" that the utilities were thought to have received at privatization. The windfall would be the amount by which an imputed value for each company at privatization (to be determined by applying a selected price-to-earnings ratio to each company's annual average profits over a multi-year period) exceeded the actual flotation price of the company. In other words, the proposal was to tax the difference between the price at which each company was actually sold and an estimated value at which it should have been sold. *Id.* at 323-324, 742-743, 1114-1117.

c. In 1997, the Labour Party regained control of the U.K. Government. As promised, in July 1997, Parliament enacted a "windfall tax" on the privatized utilities as part of the Finance (No. 2) Act, 1997, c. 58 (U.K.) (the Act). See Pet. App. 129-151. The windfall tax was a one-time tax that was required to be paid in two installments: one-half by December 1, 1997, and the other half by December 1, 1998. C.A. J.A. 304.

The Act provides that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved

the imposition of economic regulation shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." Pet. App. 129 (Pt. I, para. 1(1)). The amount of the tax was 23% of the "windfall." *Id.* at 130 (Pt. I, para. 1(2)).

The "windfall" is defined as the difference between two values: (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" minus (b) "the value which for privatisation purposes was put on that disposal." Pet. App. 138-139 (Sch. 1, para. 1). As the Board of Inland Revenue (the U.K. taxing authority) explained, "[t]he taxable amount is calculated by taking the value of the company in profit-making terms and deducting the value placed on the company at the time of flotation." C.A. J.A. 263-264.

i. The first of those two values (the profit-making value) is determined "by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio." Pet. App. 139 (Sch. 1, para. 2). A company's "initial period" is generally the first four years after flotation. *Id.* at 145-146 (Sch. 1, para. 6(1)). The "average annual profit" during that initial period is equal to the company's total profits for the initial period divided by the number of days in the initial period, multiplied by 365. *Id.* at 139 (Sch. 1, para. 2(2)).

That number is multiplied by the applicable price-to-earnings ratio, which is 9. Pet. App. 139 (Sch. 1, para. 2(3)). That figure represents the lowest average price-to-earnings ratio, during the relevant period, of the 32 companies that would be subject to the tax. *Id.* at 4; C.A. J.A. 111, 258 para. 4; 264 para. 11.

ii. The second of the two values (the flotation value) is determined by multiplying the highest price per share at which shares in the company were offered during flo-

tation by the number of shares that were offered. Pet. App. 139-140 (Sch. 1, para. 3).

The windfall tax can thus be expressed by the following formula, where P is the total profits for the company's initial period,[1] D is the number of days in the initial period, and FV is the company's flotation value (the price for which the U.K. government sold the company):

$$\text{Windfall Tax} = 23\% \times (((365 \times P/D) \times 9) - FV)$$

See Pet. App. 4.

3. SWEB paid a total windfall tax of £90,419,265. C.A. J.A. 123. Petitioner, a Pennsylvania corporation with its principal place of business in Allentown, Pennsylvania, is SWEB's parent company. Pet. App. 2; C.A. J.A. 66, 72-74, 86-88, 92-94. Under 26 U.S.C. 902, if a U.S. corporation owns at least ten percent of the voting stock of a foreign corporation and receives a dividend from the foreign corporation, the U.S. corporation is deemed to have paid (for purposes of Section 901) a portion of any foreign income tax that the foreign corporation paid on the earnings and profits from which the dividend was paid. Accordingly, in May 2000, petitioner filed a refund claim with the Internal Revenue Service (IRS), seeking a foreign tax credit for petitioner's share of the windfall tax paid by SWEB. Pet. App. 4; C.A. J.A. 127-128, 142. The IRS disallowed the claim and issued a deficiency notice. Pet. App. 4; C.A. J.A. 87, 142. Petitioner contested the deficiency notice in the United States Tax Court. Pet. App. 4; C.A. J.A. 72, 88.

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[1] The company's "total profits" refers to the company's profit on ordinary activities after tax, as determined under U.K. financial accounting principles and as reflected in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act 1985. Pet. App. 141-142 (Sch. 1, para. 5).

4. The Tax Court concluded that the U.K. windfall tax was creditable under Section 901. Pet. App. 22-87. The court rejected the Commissioner's argument that the windfall tax was a tax based on value, *i.e.*, a tax on the undervaluation of SWEB at the time of flotation. *Id.* at 79. The court explained that "a foreign levy [can] be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values." *Id.* at 81.

The Tax Court further explained that, as petitioner had argued, the windfall tax could be reformulated as a 51.71% tax on a company's profits during the initial period, to the extent those profits exceeded an average annual return of approximately 11.1% of the company's flotation value. Pet. App. 64, 83; see Pet. 8-9. Without evaluating the windfall tax under the realization, gross-receipts, or net-income tests as required by 26 C.F.R. 1.901-2(b)(1)-(4), the court concluded that the tax "did, in fact, 'reach net gain,'" and was therefore creditable under Section 901. Pet. App. 84.

5. The court of appeals reversed. Pet. App. 1-15. As an initial matter, the court explained that the Tax Court had incorrectly applied a "predominant character" standard that was detached from the three regulatory tests mandated by 26 C.F.R. 1.901-2(b)(1)-(4). Pet. App. 6 n.1. The court clarified that, in order to be a creditable income tax under Section 901, a foreign tax must satisfy each of those three tests "bas[ed] on its predominant character." *Ibid.*

The court of appeals further explained that petitioner's position suffered from a "fundamental problem": the court could not arrive at petitioner's initial-period profit as the tax base unless it applied a tax rate different from the 23% rate provided by the statute. Pet. App.

9. At petitioner's request, the court reformulated the windfall tax formula by plugging in 1461 (the number of days in four years) for D, and by disregarding the flotation value (because, according to petitioner, subtracting the flotation value was simply Parliament's way of taxing "excess" profits rather than total profits). *Id.* at 10-11. That reformulation yielded the formula:

$$\text{Tax} = 23\% \left((365 \times P/1461) \times 9\right)$$

Id. at 11. Multiplying 365 by 9 and dividing by 1461 reduces that equation to approximately:

$$\text{Tax} = 23\% \times (2.25 \times P)$$

Ibid.

The court of appeals noted that petitioner's reformulation produced a tax base of 2.25 times profit, or 2.25 times gross receipts minus 2.25 times expenses. Pet. App. 12. The court concluded that this reformulation failed the gross-receipts test because that test requires the tax base to be based on gross receipts or an approximation thereof "likely to produce an amount that is *not greater than* [the] fair market value." *Ibid.* (quoting 26 C.F.R. 1.901-2(b)(3)(i)(B)).

The court of appeals rejected petitioner's further argument that a 23% tax on 2.25 times profits is equivalent to a 51.75% tax on profits, which makes the tax base profits alone. Pet. App. 12. The court declined to view the tax in that way, noting that under petitioner's reformulation, "*[a]ny* tax on a multiple of receipts or profits could satisfy the gross receipts requirement, because we could reduce the starting point of its tax base to 100% of gross receipts by imagining a higher tax rate." *Id.* at 13-14. The court concluded that "[t]he regulation forbids that outcome." *Id.* at 14.

The court of appeals further held that the windfall tax failed to satisfy the realization test, which requires that the foreign tax be "imposed [u]pon or subsequent to the occurrence of events * * * that would result in the realization of income" under U.S. income tax provisions. 26 C.F.R. 1.901-2(b)(2)(i)(A); Pet. App. 14 n.3. The court observed that SWEB's windfall amount subject to tax (£393.1 million) was greater than its total profit during its four-year initial period (£306.2 million). Pet. App. 14 n.3. For that reason, the court stated, "[t]he U.K. windfall tax did not ensure that the companies had actually realized the amount being taxed." *Ibid.*

ARGUMENT

The court of appeals correctly held that, because the U.K. windfall tax fails to satisfy any of the regulatory criteria set forth in 26 C.F.R. 1.901-2(b)(1)-(4), it is not an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901. Although the court's decision is correct, it squarely conflicts with the Fifth Circuit's decision in *Entergy Corp.* v. *Commissioner*, 683 F.3d 233 (2012), which held that a different taxpayer was entitled to a foreign tax credit under Section 901 based on its payment of a windfall tax to the U.K. government. To further the uniform administration of the federal tax laws, the Court should resolve the conflict.

1. The U.K. windfall tax fails to satisfy any of the three regulatory criteria set forth in 26 C.F.R. 1901-2(b). The court of appeals therefore correctly held that the windfall tax is not an income tax that is creditable under Section 901.

i. The windfall tax fails the realization test because it was not imposed upon or subsequent to any realization event. 26 C.F.R. 1.901-2(b)(2)(i)(A). By its terms, the tax was imposed upon a "windfall" amount that repre-

sents the undervaluation of the company at the time of flotation. Under U.S. tax law, a tax on value or appreciation is not a tax on realized income. See *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554, 559 (1991); *Weiss* v. *Wiener*, 279 U.S. 333, 335 (1929).

Under the U.K. windfall tax, the mathematical formula used to determine a company's value includes as one variable the company's profits during the four years after flotation. The fact that value is calculated by reference to profits, however, does not mean that the U.K. windfall tax is an income tax. Calculating property value based on the property's ability to generate income is a widely used valuation method called the "income capitalization" method. See John A. Bogdanski, *Federal Tax Valuation* para. 3.05[1], [2] (2012); 2 *Bender's State Taxation: Principles and Practice* § 24.05[3] (Charles W. Swenson ed. 2012). In the United States, various property taxes permit or require taxable value to be determined based on the ability of property to generate income. See, *e.g.*, 26 U.S.C. 2032A(e)(8) (election to value family farm for federal estate tax purposes by capitalizing hypothetical rent); 26 C.F.R. 20.2031-3(b) and 25.2512-3(a)(2) (business interests must be valued for federal estate and gift tax purposes based on, *inter alia*, "demonstrated earning capacity of the business"); 26 C.F.R. 20.2031-2(f)(2) and 25.2512-2(f)(2) (for federal estate and gift taxes, stock that cannot be valued based on selling price is valued based on "company's net worth, prospective earning power and dividend-paying capacity").[2]

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[2] See also, *e.g.*, Ohio Admin. Code 5703:25-07(D)(2) (2008) (for property tax purposes, "income approach should be used for any type of property where rental income or income attributed to the real property is a major factor in determining value"); Mont. Admin. R.

Whenever the value of taxed property is calculated by reference to the income that the property has produced or is expected to produce, and the tax is in turn computed as a percentage of the property's value, the amount of the tax can always be expressed as a percentage of actual or expected income. If that mathematical relationship were sufficient by itself to render the tax an income tax, the distinction between a tax on income and a tax on the value of income-producing property would be largely eviscerated. Moreover, SWEB's total profits for the initial period were £306.2 million, but its taxable windfall amount was £393.1 million—almost £90 million more than its total profits during the initial period. That further demonstrates that the windfall tax was not imposed on past realized profits. Pet. App. 14 n.3.

ii. The U.K. windfall tax is not imposed on the basis of gross receipts, and it therefore fails the gross-receipts test. See 26 C.F.R. 1.901-2(b)(3)(i)(A). Although the windfall tax computes a company's profit-making value based on average annual profit during the initial period, which involves computation of gross receipts during that period, that average is multiplied by 9 to yield profit-making value. A company's profit-making value thus far exceeds its gross receipts during the initial period. As the court of appeals explained, a tax imposed on a value in excess of the fair market value of gross receipts fails the gross-receipts test. See Pet. App. 12-14 (citing 26 C.F.R. 1.901-2(b)(3)(ii), Ex. 3). The windfall tax was imposed on the difference between a

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42.20.107(1) (2011) ("income approach valuation" used to determine "market value of commercial properties" for property tax purposes); Wis. Stat. Ann. § 70.32(2r) (West 2011) (for property tax purposes, "[a]gricultural land shall be assessed according to the income that could be generated from its rental for agricultural use").

company's profit-making value (of which one variable is gross receipts during a defined period) and its flotation value. That tax base is a company value that is divorced from the traditional concept of gross receipts.

iii. For the same reason, the windfall tax does not satisfy the net-income test. 26 C.F.R. 1.901-1(b)(4)(i)(A). Although the company's profit-making value takes into account the company's average annual profit during the initial period, that is not the base of the tax. Net income during the initial period is one of many variables used to determine a company's profit-making value. The windfall tax imposes a tax on that value to the extent the company was undervalued at flotation.

Parliament could have employed any number of strategies, including a tax on the company's excess profits to recoup the windfall that the privatized utilities were believed to have. Parliament chose to enact a tax on the difference between the price at which each company was sold at flotation and the price at which it should have been sold, based on its ability to generate income. That is a tax on value, not an income tax.

2. Although the court of appeals' decision is correct, it squarely conflicts with the Fifth Circuit's decision in *Entergy*, *supra*. In *Entergy*, the Fifth Circuit rejected the Commissioner's argument that the windfall tax was a tax on the undervaluation of the utilities at flotation. 683 F.3d at 236-237. The court invoked case law from before the 1983 adoption of the Treasury regulation to conclude that it was not required to rely "exclusively, or even chiefly, on the text of the Windfall Tax" to determine its predominant character. *Id.* at 236.

The court in *Entergy* concluded that the windfall tax satisfied the realization test because the tax "is based on revenues from the ordinary operation of the utilities

that accrued long before the design and implementation of the tax." 683 F.3d at 236. The court further held that the net-income test was satisfied because "the tax only reached—and only could reach—utilities that realized a profit in the relevant period." *Ibid.* (emphasis omitted). The court acknowledged that "[a] tax actually directed at corporate value would not, in the ordinary instance, be imposed on the basis of gross receipts." *Id.* at 236. But the court concluded that the "practical operation" of the tax was to "claw back" a portion of the utilities' "'excess profits' in light of their sale value," and that the gross-receipts test was satisfied because those initial-period profits were calculated as "gross receipts less expenses." *Id.* at 236-237. The court noted that, under the U.K. windfall tax statute, "each utility could only be subject to the Windfall Tax after making a profit exceeding approximately an 11% annual return on its initial flotation value, and the Windfall Tax liability increased linearly with additional profits past that point." *Id.* at 238.

The Fifth Circuit acknowledged that its ruling was directly contrary to the Third Circuit's decision in this case. *Entergy*, 683 F.3d at 237-239. The Third and Fifth Circuits are thus squarely in conflict on the question presented. This Court's intervention is necessary to resolve that conflict.

3. The U.K. windfall tax was a one-time tax paid by a limited number of companies in the United Kingdom, only some of which are owned by U.S. corporations. The specific question presented in this case is therefore unlikely to recur or to have significance for a large number of U.S. taxpayers. As petitioner correctly notes (Pet. 34), however, at least one other U.S. taxpayer has an unresolved claim for a foreign tax credit based on the U.K. windfall tax. Questions may also arise concerning the

creditability under Section 901 of taxes paid under other foreign tax statutes.

By their nature, issues regarding the regulatory tests set forth in 26 C.F.R. 1.901-2(b) will necessarily arise in cases involving specific foreign tax laws that are unlikely to affect a large number of Americans. Nevertheless, this Court's guidance on the correct analytical approach for evaluating foreign taxes under Section 901 and the Treasury regulation may have significant administrative importance beyond the specific foreign tax law at issue here. And in any event, the square circuit conflict with respect to the U.K. windfall tax itself implicates the important federal interest in uniform enforcement of the federal tax laws. *Aquilino* v. *United States*, 363 U.S. 509, 514 (1960). Accordingly, the Commissioner agrees that this Court should grant the petition for a writ of certiorari to resolve the conflict between the Third and Fifth Circuits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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SEPTEMBER 2012

AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

AUG 8 -
OFFICE

No. 12-43

In the

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR *AMICI CURIAE* ROSANNE ALTSHULER, RICHARD M. BIRD, MALCOM GILLIS, ARNOLD C. HARBERGER, GARY C. HUFBAUER, CHARLES E. McLURE, JR., JACK MINTZ, AND GEORGE R. ZODROW IN SUPPORT OF PETITIONERS

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August 2012

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INTEREST OF *AMICI CURIAE*[1]

Amici are distinguished academic economists with particular expertise in the economics of taxation. Their only interest in this case is their commitment to sound tax policy and a faithful execution of the law. They have not been compensated for preparing this brief. The identities of *amici* and brief statements of their qualifications are as follows:

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[1] Counsel for all parties have been given 10 days notice as required by Rule 37.2(a) and have consented to the filing of this brief. No person other than the named *amici* or their counsel authored this brief or provided financial support for it.

consultant on tax issues to the World Bank and other national and international organizations.

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Professor Arnold C. Harberger is Distinguished Professor of Economics at the University of California at Los Angeles and Gustavus F. and Ann M. Swift Distinguished Service Professor of Economics emeritus at the University of Chicago, where he served two five-year terms as department chair.

Professor Gary C. Hufbauer is the Reginald Jones Senior Fellow at the Peterson Institute for International Economics. He was formerly Maurice Greenberg Chair and Director of Studies at the Council on Foreign Relations, Marcus Wallenberg Professor of International Financial Diplomacy at Georgetown University, Deputy Assistant Secretary of the Treasury for International Trade and Investment Policy, and Director of the International Tax Staff at the Treasury Department.

Dr. Charles E. McLure, Jr. is a Senior Fellow (emeritus) at the Hoover Institute at Stanford University. As Deputy Assistant Secretary of the Treasury from October 1983 to August 1985, McLure had primary responsibility for preparation of the Treasury Department proposals to President Ronald Reagan that became the basis of the Tax Reform Act

of 1986. He has published more than 300 articles on the economics of taxation.

Professor Jack Mintz is the Director of the School of Public Policy at the University of Calgary, where he holds the James S. and Barbara Palmer Chair, and is a research fellow of CESifo in Munich, Germany, and the Centre for Business Taxation at Oxford University. Before moving to Calgary, he was Professor of Business Economics at the Rotman School of Business at the University of Toronto, where he served as Associate Dean of the Faculty of Management, and President of the C.D. Howe Institute.

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INTRODUCTION AND SUMMARY OF ARGUMENT

Under the Internal Revenue Code, U.S. taxpayers are allowed to take a credit against their U.S. tax liability for "income, war profits, and excess profits taxes" paid to foreign governments. 26 U.S.C. § 901(b)(1). In 1997 the United Kingdom (U.K.) imposed a Windfall Tax on recently privatized public utilities. The issue in this case is whether the Windfall Tax is a tax on excess profits, and thus eligible for the foreign tax credit.

The U.S. Tax Court, in a well-reasoned opinion, which was affirmed by the U.S. Court of Appeals for the Fifth Circuit, ruled that the Windfall Tax is a creditable tax on excess profits. In a conflicting ruling, however, the U.S. Court of Appeals for the Third Circuit held that the Windfall Tax is not a creditable tax on excess profits. *Amici* urge this Court to grant certiorari to resolve the irreconcilable conflict between the two circuit courts by reaffirming the sound economic analysis that underlies the Fifth Circuit's decision and repudiating the formalistic and economically irrational reasoning underlying the Third Circuit's ruling.

From the perspective of an economist, the Windfall Tax is indisputably a tax on excess profits, even though it may superficially appear to be a tax on the difference between two values. This proposition is easily demonstrated by a simple rearrangement of terms in the formula describing the tax base that is implicit in the U.K. statute. Indeed, the Internal Revenue Service (IRS) has stipulated that this rearrangement is

mathematically equivalent to the statutory description of the tax. Pet. App. at 62 & n.20. The U.S. Court of Appeals for the Third Circuit thus went astray in finding that the tax is not a creditable tax on excess profits.

Courts have often referred to the doctrine of "substance over form" as "the cornerstone of sound taxation." *See, e.g., Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961). "Substance" is widely regarded as a matter of economic effects or reality. Yet, the Third Circuit ignored economic reality in deciding that the Windfall Tax is not a creditable excess profits tax. Instead, it focused entirely on the form of the U.K. statute in reaching its conclusion.

In determining that the U.K. Windfall Tax is not creditable, the Third Circuit rigidly applied the regulations interpreting the statute authorizing a foreign tax credit. But, as *amici* McLure and Zodrow observed in an article published in the *National Tax Journal* in 1998, the regulations do not deal adequately with excess profits taxation. Rather, they effectively define away the possibility of obtaining foreign tax credits for many forms of excess profits taxes. The Tax Court applied the regulations in a less rigid and more economically sensible manner and thus concluded correctly that the Windfall Tax should be creditable.

ARGUMENT

Tax Policy Considerations

Disallowance of a credit for taxes that should be creditable, such as the Windfall Tax, violates standard tax policy norms of equity, economic

neutrality, and international comity, and has undesirable effects on the international economic relations of the United States.

Unlike most foreign countries, the United States does not limit the tax on its residents (individual and corporate) to their domestic-source income; instead, it taxes their income from all sources, foreign as well as domestic. To prevent double taxation of its residents, the United States provides them a credit for income taxes, war profits taxes, and excess profits taxes paid to foreign governments on foreign-source income that is taxed in the United States.

The foreign tax credit is required to achieve equity among U.S. resident taxpayers. In the absence of the credit, resident taxpayers with foreign-source income that is taxed abroad would be taxed more heavily than resident taxpayers with only domestic-source income, thus creating inequity between resident taxpayers earning the same amount of income.

Equally important, the credit is required to achieve neutrality between foreign and domestic investment. In the absence of the credit, foreign investment that would otherwise be as attractive as domestic investment would be rendered less attractive. The resulting lack of neutrality between foreign and domestic investment would mean that U.S. capital would not be put to its most productive use. Seen from the perspective of the foreign country, the lack of a foreign tax credit in the United States would be tantamount to the imposition of an unwelcome exit tax on U.S. capital invested abroad.

In evaluating proposals for tax reform, foreign governments often consider whether the United States would grant a credit for the taxes being proposed. Fear that the United States might not grant such a credit can prevent adoption, or even consideration, of a tax that a foreign government might otherwise find optimal. Where the tax in question should not be creditable, as in the case of royalties disguised as taxes, there is nothing wrong with that result. However, from the standpoint of sound international policy, the IRS should not be allowed to discourage the adoption of foreign taxes that economic analysis clearly indicates should be creditable under U.S. law, simply because the foreign taxes do not take a particular form. Moreover, the unjustifiable denial of creditability is not simply a matter of comity. The fear that a credit would not be allowed for a tax that should be creditable may stifle foreign experimentation and innovation that would be beneficial to the foreign country and that the United States might find instructive.

The tax laws of foreign countries do not necessarily follow the same structure as the U.S. income tax. Yet, taxes that differ in form may have economic effects that are similar to those of the U.S. income tax. Indeed, the governing regulations recognize this fact by defining a creditable income tax as one whose "*predominant character*" is "an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1), (emphasis supplied). This means that the tax must ordinarily reach net gain, because, as a matter of substance, the levy has the characteristics of an income tax by fulfilling the realization, gross

receipts, and net income requirements specified in the regulations. *Id.* § 1.901-2. Economic effects cannot, of course, be determined by examining only the form of a tax, especially if only one feature of a tax is being considered in isolation. Instead, economic effects are inherently a matter of substance and must be considered within the context of the entire tax. Focusing solely on the form of a tax can result in denial of credit for taxes that economic analysis demonstrates should be creditable, resulting in double taxation and, consequently, inequity, non-neutrality, and the frustration of sound international tax policy.

The Economic Substance of the U.K. Windfall Tax

As a matter of economic substance, the Windfall Tax is clearly a tax on excess profits and thus should be creditable.

Beginning in 1997, the U.K. imposed an excess profits tax, the Windfall Tax, because it was thought that privatized public utilities had earned excessive profits during the initial four-year regulatory period following privatization. Tax liability was 23% of the difference between "value in profits terms" during the first four years after privatization and the amount the U.K. government realized through privatization, termed "flotation value" in U.K. parlance. "Value in profits terms" was calculated by multiplying average net income in the four years by 9, an arbitrarily chosen price-earnings ratio.

Although described in legislative terms as a tax on excess value, the tax had the economic effects of a tax on excess profits. This follows inexorably from

the fact that the calculation of "value in profits terms" was based on average net income over the four-year period, rather than on an actual measure of value (which could have easily been established from market data). Indeed, the IRS stipulated that "... the tax formula can be restated as a 51.75% tax on profits in excess of 4/9 of flotation value ...." PPL Pet. at 11 (citing Pet. App. at 62). *From an economic point of view, that statement alone is enough to demonstrate that the Windfall Tax was a tax on excess profits.* Moreover, as Professor Stewart Myers says (3d Cir. JA at 1065) and Professor Edward Maydew confirms (3d Cir. JA at 1012-14), "the U.K. Windfall Tax ... has basically the same structure as the U.S. excess profits taxes." The unavoidable conclusion is that the Windfall Tax should be creditable.

A review of the empirical evidence reinforces what the mathematics shows, namely, that the Windfall Tax was, in effect, levied on profits. First, Myers documented the close empirical relationship of tax liability to profits. Pet. App. at 59-60 & n.17. Even more compelling is the fact that, when a PPL Corporation's subsidiary's request for an increase in a deduction was granted, its tax liability dropped by exactly 51.75% of the increase in the deductible amount, confirming what Professor Maydew's numerical example shows (PPL Pet. at 7-9; Pet. App. at 44, 61-62 & n.19; 3d Cir. JA at 1009-11), to wit, that when income changes by £100, the tax changes by £51.75. This was inevitable because the effective tax rate was 51.75% and, as Myers says, "the *only moving part in the Windfall Tax machinery is net income.*" 3d Cir. JA at 1061 (emphasis in original).

The U.S. Court of Appeals for the Third Circuit stated: "If profit is in essence the only variable in the tax base, we would first need to explain away the other two variables that the U.K. statute puts there." Pet. App. at 10. This statement is disingenuous, at best; it appears to reflect a predetermination that the Windfall Tax is not a creditable tax. Although the court does not identify the "two variables" at issue, it appears that they are the flotation value and 9, the assumed price-earnings ratio. These terms are included in the description of the base of the Windfall Tax for the same reason that conventionally formulated excess profits taxes include a measure of the capital stock, for which flotation value serves as a proxy, and a rate of return above which returns are deemed to be excessive, for which 1/9 (or 11.1%) serves as a proxy, as recognized in the statement by Peter Lilley quoted in the next paragraph.

Nor is it accidental that the Windfall Tax had the economic effects of a conventional excess profits tax. That is precisely what was intended, as reflected in statements by members of both the ruling Labour Party and the opposing Conservative Party. Particularly telling is the description of the tax by Conservative Party Shadow Chancellor of the Exchequer Peter Lilley, MP, who understood perfectly the nature of the tax. He said, "They [the government] have taken average *profits* over four years after flotation. If those *profits* exceed one ninth of the flotation value, the company will pay windfall tax on the excess." Pet. App. at 42 (emphasis supplied). He advisedly spoke of the excess of *profits* over one-ninth of the flotation value, not the excess

of actual value over flotation value. Of course, his description corresponds exactly to the way conventional excess profits taxes operate.

The IRS claims that the Windfall Tax should not be creditable, because it was levied on the difference between two values. But, as both Stewart Myers (Pet. App. at 60 n.17) and Chris Osborne (Pet. App. at 78 n.29) note, "value in profits terms" is not a measure of real value or a term that is recognized in financial literature or practice; it is an artificial construct that has no economic meaning. It was calculated by multiplying *past* income by an arbitrarily chosen price-earnings ratio. But, as Myers notes (3d Cir. JA at 1045, 1055), value is related to *prospective* earnings, not past income. Moreover the price-earnings ratio utilized was not the result of a study of the earnings of the affected companies relative to their price. Rather, as Osborne (Pet. App. at 78 n.29; 3d Cir. JA at 908) states, it was an arbitrary figure chosen to reconcile the competing needs for revenue and the desire not to impose a tax that was so high that it would impede the companies' investment efforts or drive them into insolvency.

Both Osborne and Dr. Chris Wales, who were responsible for designing the tax, have stated that the Windfall Tax was structured the way it was, as the difference in two values, entirely for "'presentational' reasons," Pet. App. at 58 & n.16, that is, for presentation to the British public. The enacting legislation could just as easily, and more transparently, have described the Windfall Tax as it was described above: as 51.75% of profits in excess of 4/9 of flotation value. The choice to structure and

describe the tax differently — the form of the tax — should not affect its creditability, as it does not affect its economic effects — its substance.

That the Windfall Tax was not a tax on excess value in any meaningful economic sense also can be seen from its structure. The total profits in the first four years after privatization were divided by 4 (to convert to average annual profits) and multiplied by the arbitrarily chosen price-earnings ratio of 9 to derive "value in profits terms," which was compared with value at privatization. It makes no sense to impose a tax on value in this way. If the intent were really to tax excess value, the logical comparison would have been between the market value of stock, which was readily available, and the value at flotation. The artificial construct, "value in profits terms," would not have been used. Beyond that, even if "value in profits terms" were a meaningful term, it would make no sense to compare its average value over four years with flotation value; the tax would more logically have been levied on the difference between flotation value and market value four years after privatization. By comparison, it would be quite reasonable under an excess profits tax to compare average income over four years with an imputed return on flotation value, which is what the Windfall Tax did.

The Predominant Character of the Windfall Tax

The Windfall Tax has the predominant character of an income tax in the U.S. sense and thus should be creditable. To be creditable, a foreign tax must have the predominant character of an

income tax in the U.S. sense. Treas. Reg. § 1.901-2(a)(1)(ii). To satisfy that requirement, the tax must be "likely to reach net gain in the normal circumstances in which it applies." *Id.* § 1.901-2(a)(3). The criteria used to determine whether a tax reaches net income are realization, gross receipts, and net income. *Id.* § 1.901-2.

On its face, the Windfall Tax reaches net income. Moreover, it satisfies the realization, gross receipts, and net income criteria. The calculation of "value in profits terms" is based on *net income* during the first four years after privatization. It is clear that the income had been *realized*, as it had been reported on financial statements. Because the calculation of net income is based on *gross receipts*, the gross receipts criterion is satisfied. Because deductions are allowed for expenses, the *net income* criterion is satisfied.

The U.S. Court of Appeals for the Third Circuit concluded erroneously that the gross receipts criterion was not satisfied. Pet. App. at 14-15. To support this view, the court referred to an example in the regulations, Treas. Reg. § 1.901-2(b)(3)(ii), Ex. 3, that describes a situation in which gross receipts are deemed to be 105% of the market value of petroleum sold, suggesting that the Windfall Tax does not meet the realization test, because it is based on 225% of gross receipts. Pet. App. at 12-14. This analysis fails on several counts. First, as is well known, the example in the regulations was intended to prevent inflation of gross receipts from the sale of petroleum, in order to maximize credits. It is totally irrelevant in the present case, where the gross receipts involved were from the actual sale of utility services. *See Entergy Corp. & Affiliated Subsidiaries*

v. Comm'r, 683 F.3d 233, 237-238 (5th Cir. 2012) (discussing example and its intent). Second, as demonstrated below, the Windfall Tax was not based on 225% of profits; because of the way the tax was structured, the effective tax rate was 225% of the 23% statutory rate, or 51.75%.

The Third Circuit seems to think that the Windfall Tax should not be creditable merely because it is, in effect, levied on only *excess* profits. *See* Pet. App. at 10-11 & n.2. This assertion is absurd. The purpose of the regulations is to prevent crediting of taxes that are based on a figure *greater* than net income, calculated in the U.S. sense. They are not intended to prevent crediting of taxes that reach *less* than net income, as all excess profits taxes (including the Windfall Tax) do by taxing only excess profits. To argue otherwise is to read excess profits taxes out of the statute, even though it provides explicitly that they are creditable.

The IRS Fixation on Form over Economic Substance

The IRS's focus on form over economic substance in determining whether a tax is creditable — a position embraced by the court below — flies in the face of fundamental principles of tax policy that economic "substance" rather than "form" should be the cornerstone of sound taxation. The IRS even goes so far as to say, "[t]he words of the U.K. statute *are* the 'substance' of this tax." Pet. App. at 67 (emphasis in original). In other words, in the view of the IRS and the court below, form trumps economic substance when creditability is at stake.

That the IRS would invoke — and that an appeals court would condone — form rather than economic substance as the touchtone of creditability is truly astonishing. *That substance, which is rooted in economic reality, and not form should control sound tax analysis is the cornerstone of jurisprudence in the tax area.* As Boris I. Bittker and Lawrence Lokken write in the chapter on "Pervasive Judicial Doctrines" in their classic treatise *Federal Taxation of Income, Estates and Gifts*:

> In 1921, when today's federal income tax was still in its swaddling clothes, the Supreme Court recognized "the importance of regarding matters of substance and disregarding forms in applying the ... income tax laws." More recently, the substance-over-form principle has been called "the cornerstone of sound taxation."

Boris I. Bittker & Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 4.3.3 at 4-34 (3rd ed. 1999) (citations omitted).

The Third Circuit's and IRS's preoccupation with form over substance purportedly provides a basis for ignoring evidence of economic substance in determining creditability. This also strains credulity. The potential need to consider evidence in determining creditability under the statute is demonstrated by the fact that the regulations provide explicitly that foreign tax credits are available for a tax that fails to allow a deduction that is found in the U.S. income tax, as long as another provision compensates for that lack of deductibility. Treas. Reg. § 1.901-2(b)(4)(i). Whether

such compensation exists and is adequate is inherently a question of substance, that is, of economic effects. It would be impossible ever to meet this test if evidence extrinsic to the statute, namely economic analysis, could not be considered.

In focusing entirely on form and ignoring economic substance in their denial of the creditability of the Windfall Tax, the IRS and the Third Circuit necessarily reject the relevance of the algebraic reformulation of the Windfall Tax described above (*see* pp. 8-12 *supra*), which demonstrates that the Windfall Tax is, in economic substance, a creditable tax on income. The assertion seems to be that mathematical manipulation of the formula depends on extrinsic evidence. This also strains credulity. It is equivalent to arguing that if a statute says "2 + 3 = 5," it is illegitimate to say "5 – 3 = 2," because the arithmetic manipulation involved requires extrinsic evidence.

Despite its refusal to recognize the mathematical identity of the Windfall Tax and a plainly creditable excees profits tax, the Third Circuit engaged in some mathematical manipulation of its own. The court's mathematical analysis proceeded from the false premise that the taxpayer had claimed that tax liability was based only on first period profits, to the neglect of flotation value. Pet. App. at 9 ("Were this a tax on initial-period profit, as PPL contends that it is in substance, ..."). Based on this misinterpretation of what the taxpayer had said, the court derived several formulas for tax liability that omit flotation value. Pet. App. at 11-12. Of course, these produce the wrong result.

But the taxpayer never claimed that liability depended *only* on first-period profits. Rather it depends on the excess of first-period profits over 4/9 of flotation value. That is what makes it an *excess* profits tax, instead of merely a profits tax. Incredibly, the court explicitly recognized that "[i]n PPL's view, looking through the form of the tax to its substance reveals that 'the [t]ax [i]s, in substance, a tax on profits, specifically on excess profits.'" Pet. App. at 8-9. Moreover, this is precisely what the statute recognizes as creditable, 26 U.S.C. § 901(b)(1), the Third Circuit's decision to the contrary notwithstanding.

Ignoring flotation value, as the court did without justification, transforms the operative part of the above description of the tax — a 51.75% tax on profits in excess of 4/9 of flotation value — into "a 51.75% tax on profit ...." Pet. App. at 12. Then, arguing that the regulations do not allow restatement of the tax rate, the court deduces that the unchanged tax rate of 23% is levied on 225% of profits, in violation of U.S. law, which provides that no more than 100% of profits can be taxed. *Id.* From this misguided view, the court concludes that the gross receipts and realization criteria are not met. *Id.* This interpretation confuses statutory tax rates and effective tax rates. Although the *statutory tax rate* is only 23%, the *effective tax rate*, which is applied to exactly 100% of excess profits, is 51.75%. The Third Circuit insists on stating the tax as "Tax = 23% x [2.25 x *P*]." Pet. App. at 11. It is equally valid — and more sensible from an economic point of view — to state it as "Tax = [23% x 2.25] x *P*."

In short, by focusing narrowly on the form of a tax, to the exclusion of its substance, the IRS and the Third Circuit come to an economically irrational conclusion that the Windfall Tax is not creditable. Following this approach is likely to produce double taxation, and, as a consequence, inequity, non-neutrality, and the frustration of international tax policy objectives.

Failure of the Regulations to Track the Statute

Insofar as the regulations fail to recognize that an excess profits tax is creditable, they are not faithful to the statute.

Section 901(b)(1) of the Internal Revenue Code provides a credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. § 901(b)(1). Before describing the characteristics of an income tax, the governing Treasury regulations state:

> (a) *Definition of income, war profits, or excess profits tax* — (1) *In general.* Section 901 allows a credit for the amount of income, war profits or excess profits tax (*referred to as "income tax" for purposes of this section* ...) paid to any foreign country. ... A foreign levy is an income tax if and only if —
>
> (i) It is a tax; and
>
> (ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Treas. Reg. § 1.901-2(a)(1) (emphasis added). These regulations are not faithful to the statute, insofar as

they define away the distinction between income taxes and excess profits taxes (and war profits taxes), which the statute provides explicitly are creditable. In essence, the regulations define "income, war profits, and excess profits taxes" to be "income taxes" and then say implicitly that, to be creditable, excess profits taxes must be "an income tax in the U.S. sense" regardless of whether they constitute a war profits or an excess profits tax. Based on this illogical regulatory interpretation of the statute, the IRS finds the Windfall Tax not to be an income tax and thus not creditable.

This regulatory misinterpretation of section 901(b)(1) is analogous to the following. Suppose that (a) a statute provides a tax benefit for the raising of "chickens, ducks, and geese," (b) the regulations refer to "chickens, ducks, and geese" as "chickens," and (c) the IRS, following these regulations, rules that no tax benefit is allowed for the raising of ducks and geese, because ducks and geese are not chickens. The violence done to the statutory language of section 901(b)(1) by the regulations in section 1.901-2 is only slightly less obvious than that done in this hypothetical example. To prevent this type of travesty, the regulations misinterpreting section 901(b)(1) must be disregarded.

Amici McLure and Zodrow made this point nearly fifteen years ago in an article published in the *National Tax Journal*:

> [B]y initially referring to income, war profits, and excess profits taxes collectively as "income taxes," and then requiring that, to be creditable, the foreign tax must be "an

> income tax in the U.S. sense" ..., the regulations are not faithful to the wording of the statute. (Fn. ref. omitted) Since the structures of income and excess profits taxes are inherently different, these differences should be taken into account explicitly in the regulations; specifically, there should be separate criteria defining what is creditable as an income tax and what is creditable as an excess profits tax.

Charles E. McLure, Jr. & George R. Zodrow, *The Economic Case for Foreign Tax Credits for Cash Flow Taxes*, 51 NATIONAL TAX JOURNAL 1, 8-9 (Mar. 1998). Once it is recognized that the regulations do not deal with war profits and excess profits taxes, it is clear that taxes not structured like the U.S. income tax may nevertheless qualify for foreign tax credits.

Wider Relevance of the Issue

The importance of creditability of taxes that do not look exactly like the U.S. income tax goes far beyond the creditability of the U.K. Windfall Tax. The wider relevance of this issue can be seen from the following episode, which is documented in the *National Tax Journal* article cited above as well as in Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Consumption-Based Direct Tax Proposed for Bolivia*, 1 INTERNATIONAL TAX AND PUBLIC FINANCE 97 (1996).

In the mid 1990s the President of Bolivia, Gonzalo Sanchez de Lozado, expressed strong interest in proposing a business cash flow tax (of which the flat tax is an example). Acting as

consultants to the government of Bolivia, *amici* McLure and Zodrow examined the creditability issue carefully and concluded:

a) that the regulations do not accurately reflect the wording of the statute they are intended to interpret;

b) that the business cash flow tax could be interpreted as a tax on excess profits, and thus should be creditable under section 901(b) (1);

c) that the business cash flow tax should be creditable under strict application of the regulations, because, as a simple matter of economics, the first-year write-off of all investment would more than compensate for the lack of a deduction for interest;

d) that in the particular circumstances of Bolivia the business cash flow tax would have had the "predominant characteristics of an income tax," as defined under U.S. law, even if the benefit of first-year write-off were ignored; and

e) that credit for the business cash flow tax would reduce U.S. revenue less than credit for a conventional income tax levied at the same rate.

President Sanchez de Lozado and *amici* McLure and Zodrow met with a representative of the IRS. The President explained that he was considering proposing a business cash flow tax solely because of its domestic advantages, and *amici* McLure and Zodrow made the foregoing arguments for the creditability of such a tax. The IRS representative replied that none of the arguments mattered, because, "we look at form, not substance." Faced with this intransigence and the risk that the

business cash flow tax might not be creditable, the President had no alternative but to succumb and propose a conventional income tax.

As *amici* McLure and Zodrow observed in their *National Tax Journal* article, by emphasizing form over substance, in direct contradiction of both statutory and regulatory authority, the IRS is unduly influencing the forms of taxation foreign governments can consider. The IRS is thereby violating both the best economic interests of the United States and international comity by discouraging the adoption by foreign governments of taxes that many economists in the U.S. and elsewhere have argued are superior to the traditional income tax.

CONCLUSION

For all of the reasons stated above, this Court should grant certiorari in this case to resolve the conflict between the decisions of the Fifth Circuit Court of Appeals, which decided correctly that credit should be allowed for the U.K. Windfall Tax, and that of the Third Circuit, which erred seriously in deciding that the Windfall Tax is not creditable. Failure to resolve the split would perpetuate undesirable uncertainty regarding creditability for many U.S. corporations considering foreign investments. Worse, affirming the decision of the Third Circuit would create the specter that foreign taxes that meet both the statutory and regulatory criteria for creditability might not be found creditable, merely because they do not follow a form dictated by the IRS, acting with no statutory or

regulatory basis. *Economic substance, not formalism, should govern the eligibility for the foreign tax credit.*

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August 2012

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AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

Supreme Court, U.S.
FILED
AUG 7 - 2012
OFFICE OF THE CLERK

No. 12-43

IN THE

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF OF *AMICUS CURIAE* N. JEROLD COHEN, CAROL P. TELLO, AND SHANE A. LORD IN SUPPORT OF PETITIONERS' REQUEST FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in determining the creditability of a foreign tax, courts should employ an approach that relies on the form of a foreign tax statute or an approach that looks to the operational substance of the foreign tax statute.

INTEREST OF *AMICUS CURIAE*

We practice in the tax law area and are frequently confronted with questions concerning foreign tax credit matters.[1] One of *Amicus Curiae*, N. Jerold Cohen, was a former Chief Counsel of the Internal Revenue Service and, as such, participated in the formulation of the foreign tax credit regulations at issue in this case. Another, Carol P. Tello, is a well-known international tax lawyer and Chair of the Committee of the Tax Section of the American Bar Association concerned with foreign tax credits. The third, Shane A. Lord, works closely with Mr. Cohen, Ms. Tello, and other tax attorneys. As tax practitioners, we have an obligation to properly advise and protect both our clients and the tax system. When a key element of the tax law becomes clouded by contradictory holdings of two different circuits of the U.S. Court of Appeals, our ability to properly advise our clients and balance our obligation to them and the tax system becomes difficult. Determining the proper credibility of foreign taxes is just such a key element.

The two circuit court cases at issue here are diametrically opposed as to the applicability of the doctrine of form versus substance in resolving the determination of foreign tax creditability. Form versus substance is a key doctrine of tax law that permeates the tax law, affecting almost all tax determinations.

The question raised by the conflicting decisions in the two circuits is whether the taxpayer is required

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. The parties received timely notice of *amicus curiae's* intent to file this brief. Petitioner and respondent have consented to the filing of this brief. Petitioner's consent letter has been filed with the Clerk of this Court. A copy of respondent's consent letter is being submitted with this brief.

to look to the substance of the foreign tax statute in determining whether the tax is a creditable foreign tax or is bound by its form. This split in the approach to foreign tax credits by the two circuits does not merely affect the particular foreign tax at issue in this matter. It affects, and will affect, many determinations as to the credibility of foreign taxes in general. Furthermore, the applicability of a form versus substance analysis in other areas of the tax law could be affected by a determination as to which of the two circuit courts applied the correct approach.

The Fifth Circuit and U.S. Tax Court have determined that the substance of a foreign tax is the determinative factor in deciding the credibility for U.S. tax purposes of the foreign tax. The Third Circuit has determined that the form of the foreign tax provision actually governs. This dichotomy between the Fifth Circuit and Third Circuit holdings regarding the application of the substance over form doctrine in the foreign tax credit area threatens to disrupt the ability of tax practitioners to properly advise their clients. The contradictory holdings in the circuits raise questions for tax practitioners that must be answered for them to uphold their obligation to the U.S. tax system and their clients.

Thus, it is paramount for tax practitioners and taxpayers that this circuit conflict be resolved. As tax practitioners, the split between the circuits regarding the doctrine of form versus substance has large tax policy ramifications that affect both the advice provided to our clients and our ability to protect the integrity of the tax system.

STATEMENT OF THE CASE

To avoid double taxation, section 901 of the Internal Revenue Code allows U.S. taxpayers a tax credit

for income, war profits, or excess profit taxes paid to another country. In defining such taxes, Treasury Regulation § 1.901-2(a)(1) provides that a foreign tax is a creditable tax "if and only if—(i) It is a tax; and (ii) The predominant character of that tax is that of an income tax in the U.S. sense."

While this case involves application of section 901 to a "windfall tax" imposed by the United Kingdom, the broader implication of this case involves the general test of foreign tax creditability for all U.S. taxpayers. The key to that test is whether the "predominant character" of a foreign tax is "an income tax in the U.S. sense."

The "windfall tax" in this case is on the excess "value" of certain companies that were privatized in the 1980s and 1990s above their privatization price. The excess "value" was measured by the companies' profits during the four years immediately after privatization. While the form of the statute would clearly indicate intent to tax the "value" of the companies, the tax's practical effect is to impose a tax on the "excess profits" of the companies during the four year period after privatization.

Consistent with the form of the statute, the Commissioner has taken a position that the "windfall tax" is on "value," not income, and, therefore, is not a creditable foreign tax. The Tax Court held against the Commissioner, finding that the tax, in substance, is the equivalent of an income tax in the U.S. sense. The Third Circuit reversed the Tax Court. The Third Circuit deemed the tax non-creditable because the U.K. statute provides that the tax is on the difference between two values.

In a case arising out of the same U.K. tax, same tax court proceedings, and same evidentiary record, the

Fifth Circuit reached the opposite conclusion and affirmed the Tax Court's holding. Recognizing that it was creating a circuit split, the Fifth Circuit criticized the Third Circuit's analysis and held that courts must look beyond the form of a foreign tax statute and consider the tax's practical operation when determining whether it is creditable for U.S. tax purposes. The Third Circuit and Fifth Circuit holdings are in conflict as to the critical question of whether (or to what degree) the form of a foreign tax statute determines the "predominant character" of a tax. The application of this key test for creditability of foreign taxes impacts every U.S. taxpayer.

The Court should grant certiorari to resolve this circuit conflict, which is not limited to the particular tax at issue in the cases.

REASONS FOR GRANTING THE PETITION

1. The split in the decisions by the Fifth Circuit and Third Circuit results from two diametrically opposed views of the proper factors in determining the credibility of a foreign tax. While the issue of determining the credibility of this particular foreign tax may not be one that reaches a great number of U.S. companies, the interpretation of the relevant Treasury regulations is important to a great number of U.S. taxpayers and generally has widespread ramifications.

2. At the present time, there are three courts that have addressed the proper approach to the credibility of this foreign tax. The Fifth Circuit and Third Circuit Courts of Appeals have set out two entirely different approaches to making this determination. This is so even though they were considering the same tax and the same lower court determination. That lower court was the United States Tax Court.

While the U.S. Tax Court has nationwide jurisdiction, under its precedent of *Golsen v. Commissioner*, 54 T.C. 742 (1970), it is bound to follow the holding of the circuit to which a case it is considering would be appealed. Since the U.S. Tax Court hears over 90 percent of the disputed tax cases, this creates a strange result in which it might find a tax credible for taxpayers in the Fifth Circuit who bring a case to it while rejecting creditability for the same tax for taxpayers in the Third Circuit.

3. Thus this conflict between the circuits means that the approach to the determination of whether a foreign tax is or is not credible will depend upon the taxpayer's residence or principal place of business. Not only is that result unsatisfactory from the point of view of administration of the United States' income tax laws, but it puts tax advisors in a difficult position. Must they wait to see which of the two courses will be followed in other jurisdictions or make a guess as to that outcome?

4. When there is such a split between the circuits with regard to a key doctrine of tax law, taxpayers and their advisors expect the Supreme Court to resolve the matter. If there were a way to resolve the split, to reconcile the decisions, then all may be required to be patient and await further guidance as other courts wrestle with this issue. Here, however, there is absolutely no way to reconcile these decisions. Either credibility is to be determined under the approach taken by the Third Circuit or by the Fifth Circuit.

5. Under these circumstances, we believe that this is a matter to be resolved by the Supreme Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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August 7, 2012

AMICUS CURIAE BRIEF

AND
BRIEFS

No. 12-43

SUPREME COURT, U.S.
FILED
AUG 10 2012
OFFICE OF THE CLERK

In The
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

BRIEF FOR SOUTHEASTERN LEGAL FOUNDATION, CATO INSTITUTE, AND GOLDWATER INSTITUTE AS *AMICI CURIAE* IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, contrary to decades of case law, it is correct to look only at the terminology or formula used in a foreign tax statute and not to consider the purpose and economic substance of the foreign government's tax assessment in determining whether, under U.S. law, an American taxpayer who pays the foreign tax may claim the traditional statutory right against double taxation found in section 901 of the Internal Revenue Code.

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INTEREST OF *AMICI CURIAE*[1]

Southeastern Legal Foundation ("SLF") is a not-for-profit national constitutional public interest law firm and policy center that promotes the public interest in the proper construction and enforcement of the laws and Constitution of the United States in the courts of law and through public discourse. SLF advocates constitutional individual liberties, limited government, and the free enterprise system in its litigation cases and *amicus* participation in state and federal courts.

While SLF is by no means a single-issue organization, about half of the litigation matters and policy debates in which SLF has participated since its founding in 1976 have involved the vindication of private property rights. SLF has represented parties and submitted *amicus* briefs before this Court in numerous cases presenting governmental threats to the property rights of individuals and businesses, including through overreaching use of eminent domain powers and excessive and imbalanced regulation. SLF prides itself on defending ordinary citizens and small business owners in local communities throughout America who find their freedom and their

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[1] All parties received timely notice of the intent to file this brief and have consented to its filing in letters on file with the Clerk of the Court. No counsel for a party has authored this brief in whole or in part, and no person other than *amici* and their counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.2(a), 37.6.

property under challenge from arbitrary and unreasonable bureaucratic power.

The Cato Institute ("Cato") was established in 1977 as a nonpartisan public policy research foundation dedicated to the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the constitutional limits on government that are the foundation of freedom. Toward those ends, Cato publishes books and studies, conducts conferences and forums, and publishes the annual *Cato Supreme Court Review*. Cato participates from time to time as an *amicus* in important cases implicating fundamental liberties, free markets, and judicial checks on arbitrary government action.

The Goldwater Institute ("Goldwater") is a nonprofit educational foundation that was established in 1988. Through litigation, research papers, editorials, policy briefings, and forums, Goldwater advances non-partisan public policies founded upon the principles of limited government, economic freedom, and individual responsibility. Goldwater participates in court cases and frequently files *amicus* briefs through its Scharf-Norton Center for Constitutional Litigation.

Amici file this brief because the legal position taken below by the Commissioner of Internal Revenue—which has precipitated directly conflicting decisions from two courts of appeals—raises basic issues of agency power that transcend the interests of

any particular taxpayer or class of taxpayers. This case concerns the limits of the power of a federal agency to apply a statute originally focused on economic substance in a manner that utterly ignores the true nature of the underlying transaction. *Amici* urge the Court to take up this case, not only to resolve the clear circuit split, but also to rein in the Commissioner's discretion to act against the property interests of individuals and businesses through an overly formalistic reading of the law that only serves the convenience and institutional self-interests of the tax collector.

SUMMARY OF ARGUMENT

The Court should grant certiorari to resolve the uncertainty created for taxpayers by the direct conflict between the Courts of Appeals for the Third and Fifth Circuits concerning the correctness of the Commissioner's effort to apply the allowance of credit for foreign "excess profits taxes" found in section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1). There are compelling reasons to reject the judgment of the Third Circuit in favor of the Fifth Circuit's substance-focused approach, which is fully consistent with the historical understanding of section 901 approved long ago by this Court and in previous lower court decisions.

Most fundamentally, this case presents an important opportunity for the Court to ensure that

taxpayers will not lose their right to avoid double taxation through a contrivance of administrative Newspeak. The application of section 901 espoused by the Commissioner and approved by the Third Circuit takes a venerable principle of the tax code that has long been held to require an examination of the true underlying purpose and operation of a foreign tax and converts it into a mechanical review that refuses to look beyond the superficial language of the foreign law.

It is telling that here the Commissioner has invoked this myopic approach to section 901 to deny the taxpayer a foreign tax credit and coincidentally to advance the revenue-raising objectives of the Internal Revenue Service ("IRS"). Not surprisingly, in cases where the IRS believes the literal terms of a foreign tax provision tend to disguise its true character, the Commissioner has not hesitated to present extensive evidence of the tax's underlying purpose and economic substance as a basis to deny the taxpayer a credit under section 901. The self-serving nature of the Commissioner's current position is a ringing alarm that calls out for this Court's review.

ARGUMENT

THE COURT SHOULD GRANT REVIEW TO SETTLE THE CIRCUIT SPLIT AND SAVE AMERICANS FROM AN ADMINISTRATIVE OVERREACH THAT BREAKS FAITH WITH THE HISTORICAL UNDERSTANDING OF THE LAW AT ISSUE.

A. This Case Presents an Intolerable Conflict Between the Hyper-Formalism of the Third Circuit and the More Traditional Substance-Based Approach of the Fifth Circuit.

The Commissioner's argument for denying taxpayers a section 901 credit for payment of the United Kingdom's Windfall Tax has spawned a direct conflict between the Third Circuit's opinion below and the Fifth Circuit. *Compare* Pet. App. 15 ("we hold that the [U.K.] windfall tax is not creditable") *with Entergy Corp. v. Comm'r*, 683 F.3d 233, 239 (5th Cir. 2012) ("We . . . disagree with the Third Circuit's conclusion and hold that the Windfall Tax is a creditable foreign income tax. . . .").

The court below accepted the Commissioner's position that the Windfall Tax should not be treated as a tax on net income for purposes of Treasury Regulation 1.901-2 (the IRS rule interpreting section 901), because, according to the U.K. statute's taxing formula, the law's 23-percent tax rate is levied against the difference between the historical purchase price paid for the businesses in question (called the "flotation value") and a calculated "profit-making

value," rather than against a simpler measure of net income. *See* Pet. App. 8-15. At the Commissioner's urging, the court refused to look beyond the literal terms of the statute to the substance and purpose of the tax, which was clearly intended to, and did, capture only that subset of net income (about 52 percent of actual profits earned above a prescribed rate of return during a four-year period) that the British Parliament determined represented "excess profits" for the businesses. *See id.*

The Fifth Circuit followed a very different path. Rejecting the Commissioner's claim that the court "should rely exclusively, or even chiefly, on the text of the Windfall Tax," 683 F.3d at 236, Chief Judge Jones stressed the reasoning in the historical line of cases applying section 901. Those cases teach that "[t]he label and form of the foreign tax is not determinative," *Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982); whether or not the foreign levy "is labeled a gross income or a net income tax" or uses some other "form" or "name," "[t]he important thing is whether the other country is attempting to reach *some net gain*," *Bank of Am. Nat. Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972) (emphasis added). *See* 683 F.3d at 236.[2] Applying this

[2] This Court's longstanding interpretation of section 901 reflects the same view. In *Biddle v. Comm'r*, 302 U.S. 573 (1938), the Court held that a taxpayer who was a shareholder in a British corporation was not entitled to a credit for a British income tax assessed on the taxpayer's proportionate share of the taxes paid by the corporation on its own profits. *Id.* at 575,

(Continued on following page)

traditional analysis, the Fifth Circuit held that it was proper to allow a credit for payment of the U.K. Windfall Tax. *Id.* at 238.

Certainly, if unresolved, the conflict between the opposing approaches taken by the Fifth Circuit in *Entergy Corp.* and the Third Circuit in this case will leave American taxpayers in an untenable quandary. Taxpayers in Texas, for example, will continue to be guided by the traditional inquiry that looks through the terminology of the foreign tax law to its actual substantive effect, whereas the availability of the credit for taxpayers in Pennsylvania and New Jersey will be determined by the language used in the foreign country's statute. That situation is unfair and intolerable, and this Court should grant review to put an end to it.

B. The Commissioner's Self-Serving Position Is a Stark Departure from the Language and Traditional Interpretation of Section 901.

First enacted in 1918 and substantially unchanged in 94 years, section 901 permits U.S. citizens

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580-82. These amounts, although denominated "income" in the U.K., were not actually received by the shareholder as dividends and would not be considered taxable income under the U.S. tax code, and thus the taxpayer would not face double taxation in the absence of a credit. *See id.* at 581-82. Importantly, the Court reasoned that the availability of a credit under section 901 is not determined "by reference to foreign characterizations and classifications of tax legislation." *Id.* at 579.

and businesses a credit for "the amount of any income, war profits, and excess profits taxes paid" to a foreign country. 26 U.S.C. § 901(b)(1). The credit allowance was designed "to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

One would think there is little room for doubt that the British Windfall Tax is an "excess profits tax" within the plain meaning and traditional understanding of section 901. It was enacted in 1997 by the British Labour Government for the express purpose of taxing what Parliament figured were "excess" or "windfall" profits earned by businesses that had been privatized by the earlier Conservative Government, and it creates the very real threat of double taxation for U.S. owners of the affected businesses. *See* Pet. 5-9.

Yet the Commissioner today would deny this tax credit and ignore the substantive effect of the Windfall Tax simply because the U.K. statute, in setting out the formula for calculating the tax, uses the term "profit-making value" instead of the magic words "net income" and "gross receipts"—in other words, because it expresses the tax rate as a percentage of an imputed value (albeit one calculated on the basis of actual profits), rather than directly as a percentage of net income. The Commissioner maintains that taxpayers may not probe behind the language of the statute and the Tax Court may not consider evidence of the statute's purpose and substantive effect, *see* Pet. App.

8, even though such evidence has commonly been presented in prior cases under section 901.[3]

How did we get here? How could the Commissioner so thoroughly jettison the "Oldspeak" of section 901, as traditionally understood, in favor of this Orwellian Newspeak?[4]

The first step in this transformation was Treasury Regulation 1.901-2, promulgated in 1983 and loosely based on the case law that had developed under section 901. Regulation 1.901-2 conflates the three types of taxes listed in section 901 ("income, war profits, and excess profits taxes") into a single concept of "income tax," which it then defines as a foreign tax "[t]he predominant character of" which "is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii); Pet. App. 109. The rule further specifies that the

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[3] *See Inland Steel*, 677 F.2d at 82 (exploring "History and Purpose" of foreign tax); *see also Texasgulf, Inc. v. Comm'r*, 172 F.3d 209, 211-14 (2d Cir. 1999) ("Essential to the resolution of this appeal is an understanding of the nature and operation of the [foreign tax] during the relevant taxable years.") (discussing trial evidence, including expert testimony, on "the industry-wide operation" of the tax). The rules of procedure for both the Tax Court and the district courts make it clear that in determining a foreign law, the court "may consider any relevant material or source, including testimony, whether or not submitted by a party or otherwise admissible." Tax Ct. R. 146; *see* Fed. R. Civ. P. 44.1 (same).

[4] *See* George Orwell, *Nineteen Eighty-Four* 255 (New American Library ed. 1981) (Appendix: "The Principles of Newspeak") ("When Oldspeak had been once and for all superseded, the last link with the past would have been severed.").

"predominant character" test is satisfied only if the foreign tax "is likely to reach net gain in the normal circumstances," and only if, "judged on the basis of its predominant character," the tax meets three technical requirements: (1) It is imposed upon or after the "realization" of income; (2) it is imposed on the basis of "gross receipts," and (3) the base of the tax constitutes "net income"—"gross receipts" less "significant costs and expenses." Treas. Reg. 1.901-2(b)(2), (3), (4); Pet. App. 114, 120, 122.

One may question why the IRS needed to graft this multi-factor test onto the plain language of section 901, but in practice the regulation has heretofore been applied consistently with the substance-over-form reasoning followed in the courts.

Thus, the Fifth Circuit in *Entergy Corp.* had no problem concluding that the U.K. Windfall Tax satisfies the substantive requirements of Treasury Regulation 1.901-2's "predominant character" test: The tax was based on, and increased in proportion to, a subset of the financial profits (*i.e.*, net income) *actually realized* by the affected businesses during a particular period, which means that it was necessarily levied on gross receipts less operating expenses and could never exceed any appropriate measure of income. *See* 683 F.3d at 238. "The tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor. That Parliament termed this aggregated but entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect

of the tax, that is, its predominant character." *Id.* at 236-37.[5]

The problem presented in this case, however, is that the Commissioner's current position severs the last link to any meaningful examination of the foreign tax's "history and actual effect." It abandons all vestiges of the substantive "predominant character" test in favor of a rote, mechanical application of the regulatory sub-factors to the literal language of the foreign statute.

That this position is unfaithful to the old statute is underscored by its self-serving nature. It has the look of a litigating position, adopted out of convenience and selectively applied by the IRS only where it works against the taxpayer and increases the returns to the tax collector. Indeed, there have been many court cases over the decades where the shoe was on the other foot and it was the Commissioner who urged a substantive examination into the nature and effect of the foreign tax to show that the credit should be disallowed. *See, e.g.*, *Biddle v. Comm'r*, 302 U.S. at 579 (noting that the Board of Tax Appeals made

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[5] The Fifth Circuit explained that the "gross receipts" requirement in the regulation is designed "to prevent foreign nations from 'soaking up' American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount *greater than the business's actual gross receipts*." 683 F.3d at 237 (emphasis added) (citing Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates & Gifts ¶ 72.1 (2011)).

findings in the Commissioner's favor "supported . . . by much expert testimony," and mandating, at the urging of the Commissioner, "an examination of the manner in which the British tax is laid and collected . . . and whether it is the substantial equivalent of payment of the [income] tax as those terms are used in our own statute").

The Commissioner's hyper-formalistic application of section 901, as approved by the Third Circuit, threatens taxpayers with the arbitrary denial of their traditional statutory right against "the evil of double taxation." The abrupt break from the historical understanding of section 901 will inevitably subvert the stability and predictability of financial transactions for U.S. individuals and companies with business interests overseas.

In short, the position upheld below represents a dangerous exercise of administrative power, and this case gives the Court an important opportunity to reaffirm the substantive protection originally granted by Congress.

CONCLUSION

For the foregoing reasons, *amici curiae* urge the Court to grant the petition for writ of certiorari.

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August 10, 2012

JOINT APPENDIX

RECORD
AND
BRIEFS

Supreme Court, U.S.
FILED
DEC 13 2012
OFFICE OF THE CLERK
SUPREME COURT

No. 12-43

In the
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PPL CORPORATION AND SUBSIDIARIES,
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v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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December 13, 2012

Petition for Writ of Certiorari Filed July 9, 2012
Petition for Writ of Certiorari Granted Oct. 29, 2012

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The following opinions, decisions, judgments, and orders have been omitted in printing this joint appendix because they appear on the following pages in the appendix to the Petition for Certiorari:

Opinion of the United States Court of Appeals for the Third Circuit (Dec. 22, 2011) Pet.App-1

Amended Judgment of the United States Court of Appeals for the Third Circuit (Jan. 13, 2012).....Pet.App-16

Order of the United States Court of Appeals for the Third Circuit Regarding Motion to Clarify (Jan. 13, 2012) Pet.App-18

Order of the United States Court of Appeals for the Third Circuit Denying Petition for Panel Rehearing (Mar. 9, 2012) Pet.App-20

Opinion of the United States Tax Court (May 5, 2011) Pet.App-22

Relevant Statutes & Regulations

26 U.S.C. § 901 ..... Pet.App-88

Treas. Reg. § 1.901-2 ..... Pet.App-109

Finance (No. 2) Act, 1997, c.58 (U.K.) Pet.App-129

UNITED STATES TAX COURT

PPL CORPORATION & SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

RELEVANT DOCKET ENTRIES

NO. 25393-07

Date Filed	#	Document
11/05/2007	1	Petition.
	* * *	
01/08/2008	7	Answer.
	* * *	
06/19/2008	13	Joint Motion to Modify Pretrial Order.
06/19/2008	14	Order, Court Accepts and Adopts the Parties Pretrial Order.
06/23/2008	15	Motion by Petitioners for Partial Summary Judgment.
	* * *	
07/23/2008	19	Objection by Respondent to Motion for Partial Summary Judgment.
07/23/2008	20	Motion by Respondent (Cross) for Partial Summary Judgment.

07/23/2008	21	Memorandum of Authorities by Respondent in Support of Objection to Motion for Partial Summary Judgment and Cross Motion for Partial Summary Judgment.
	* * *	
08/22/2008	27	Response by Petitioner to Cross Motion for Partial Summary Judgment with Memorandum of Law in Support Attached.
09/27/2008	28	Order, Petitioners Motion (15) and Respondents Motion (20) are DENIED.
	* * *	
09/25/2008	33	Stipulation of Facts.
	* * *	
10/14/2008	43	Trial Before Judge Halpern. Also called Oct. 15, 16, 20, and 21, 2008.
10/14/2008	44	Stipulation of Facts.
10/14/2008	45	Second Stipulation of Facts.
	* * *	
10/20/2008	48	Third Stipulation of Facts.
	* * *	
10/23/2008	52	Order, Petitioner Address in its Brief Certain Issue.

	* * *	
10/22/2008	57	Brief for Respondent.
10/22/2008	58	Brief for Petitioner.
	* * *	
2/24/2009	60	Reply Brief for Respondent.
2/24/2009	61	Reply Brief for Petitioner.
	* * *	
06/26/2009	63	Supplement to Brief by Petitioner.
07/28/2009	64	Motion by Respondent to Strike Supplement to Brief by Petitioners.
08/24/2009	66	Response by Petitioner to Motion to Strike Supplement to Petitioners Brief.
8/31/2009	67	Order, Motion (64) to Strike Supplement to Brief by Petitioners is DENIED in Part and GRANTED in Part in that the Court Will Strike from Petitioners Supplement to Brief References to Mr. Alexander's Statements.
10/22/2009	68	Motion by Petitioner to Supplement Record.
11/13/2009	70	Objection by Respondent to Motion to Supplement Record.

11/20/2009	71	Order, Petitioner Motion (68) to Supplement Record is Granted in that the Court Takes Judicial notice of the Preprint.
12/11/2009	73	Supplemental Brief of Respondent.
12/11/2009	74	Supplemental Brief of Petitioner.
07/28/2010	75	Opinion, Judge Halpern, 135 T.C. No. 8.
09/09/2010	76	Opinion, Judge Halpern, 135 T.C. No. 15 (Decision Will Be Entered Under Rule 155).
* * *		
10/14/2010	79	Decision Entered, Judge Halpern.
01/04/2011	80	Notice of Appeal by Respondent to the U.S. Court of Appeals for the Third Circuit.
01/07/2011	81	Notice of Filing with Copy of Notice of Appeal Sent to the Parties.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

PPL CORPORATION & SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

RELEVANT DOCKET ENTRIES

NO. 11-1069

Date Filed	Document
01/12/2011	Tax Court Case Docketed. Notice filed by Appellant Commissioner of Internal Revenue.
* * *	
01/20/2011	Concise Summary of the Case filed by Appellant Commissioner of Internal Revenue.
* * *	
05/05/2011	Joint Appendix, Vols. 2 - 7, Part 1.
05/05/2011	Joint Appendix, Vols. 2 - 7, Part 2.
05/05/2011	Joint Appendix, Vols. 2 - 7, Part 3.
05/05/2011	Joint Appendix Corrections.
05/05/2011	Brief with Volume 1 of Joint Appendix Attached filed by Appellant Commissioner of Internal Revenue.
* * *	

06/09/2011	Brief with Addendum filed by Appellee PPL Corporation.
	* * *
6/10/2011	Brief of Amicus Curiae filed by American Electric Power Co. in Support of Appellee.
	* * *
07/05/2011	Reply Brief filed by Appellant Commissioner of Internal Revenue.
	* * *
07/13/2011	Supplemental Brief with Addendum filed by Appellee PPL Corporation.
	* * *
09/22/2011	Argued on Thursday 09/22/2011 before AMBRO, CHAGARES and *GARTH, Circuit Judges. (*Participated in Video Conference).
	* * *
10/04/2011	Transcript of Oral Argument on 09/22/2011, Prepared at the Direction of the Court.
	* * *
11/10/2011	Letter, Rule 28j filed by Appellee PPL Corporation.

12/22/2011	PRECEDENTIAL OPINION, Coram: AMBRO, CHAGARES and *GARTH, Circuit Judges. Judge AMBRO Authoring. We Hold that the Windfall Tax is Not Creditable and Reverse the Decision of the Tax Court. (*Participated in Video Conference).
12/22/2011	JUDGMENT, Reversed. Costs taxed Against Appellee.
	* * *
01/12/2012	Unopposed Motion to Clarify the Judgment filed by Appellee PPL Corporation.
01/13/2012	ORDER (AMBRO, CHAGARES and GARTH, Circuit Judges) Granting Unopposed Motion. An Amended Judgment Shall Be Issued, Filed AMBRO, Authoring Judge.
01/13/2012	AMENDED JUDGMENT, Ordered and Adjudged by this Court that the Decision of the Tax Court dated October 14, 2010, is Hereby Reversed to the Extent that the Decision Reflect the Tax Court's Opinion that the U.K. Windfall Tax is Creditable Foreign Tax and We Remand the Case to the Tax Court to Consider the Dividend Recission Issue. Costs Taxed Against Appellee, Filed.

02/27/2012	Petition for Rehearing Before Original Panel filed by Appellee PPL Corporation.
	* * *
03/09/2012	ORDER (AMBRO, CHAGARES and GARTH, Circuit Judges) Denying Petition for Panel Rehearing, Filed AMBRO, Authoring Judge.
	* * *
03/20/2012	MANDATE ISSUED.
	* * *
07/12/2012	Notice from U.S. Supreme Court. Petition for Writ of Certiorari filed by PPL Corporation.

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

FIRST STIPULATION OF FACTS AND EXHIBITS

OCTOBER 14, 2008

In accordance with Rule 91(e) of the Tax Court Rules of Practice and Procedure, the parties stipulate and agree that, for purposes of this case, the following numbered paragraphs shall be accepted as facts, except as otherwise indicated, and all the attached referenced exhibits are considered authentic and are incorporated in, and made part of, this stipulation; provided, however, that either party has the right to object to the admission of any facts and exhibits in evidence on the grounds of relevancy and

materiality, but not on other grounds unless expressly reserved herein, and subject to the rights of the parties to introduce other evidence not inconsistent with this stipulation (including any supplemental stipulations of fact).

The parties do not necessarily agree to the truth of the assertions within stipulated exhibits and such assertions may be rebutted or corroborated by additional evidence. In addition, the parties, in stipulating to facts and exhibits for evidentiary purposes, do not necessarily agree to the substantive relevance and materiality of those facts and exhibits to the particular litigating positions of the respective parties.

Unless otherwise indicated, the statements in this stipulation are with respect to petitioner's tax year ended December 31, 1997 (1997 or the year in issue). The captions and internal headings used in this stipulation are for convenience and organizational purposes only and do not constitute stipulated facts or admissions.

I. Jurisdiction

1. Petitioner PPL Corporation is a Pennsylvania corporation and it is the common parent of an affiliated group of corporations making a consolidated return of income.

2. During 1997, petitioner was known as PP&L Resources, Inc., and petitioner's affiliated group was referred to as PP&L Resources, Inc. and subsidiary Companies.

3. References to petitioner refer to PPL Corporation or PP&L Resources, Inc., and its respective affiliated group, for the appropriate tax year or time period involved.

4. On October 25, 2007, respondent sent by certified mail to petitioner's last known address a statutory notice of deficiency in Federal income tax for petitioner's 1997 tax year (the notice) .

5. **Exhibit 1-J** is a copy of the notice.

6. In the notice, respondent determined a corporate income tax deficiency of $10,196,874 for 1997. The deficiency was based upon the following unagreed adjustments:

(a) Increases in taxable income of $18,606,135 and $1,476,120, arising from respondent's denial of claimed depreciation deductions for petitioner's street and area lighting assets (Street Light Issue); and

(b) An increase in taxable income of $9,051,671, arising from the inclusion as dividend income of a distribution that petitioner received from an indirect foreign subsidiary (Dividend Rescission Issue).

7. In the notice, respondent also denied petitioner's claim for refund of $786,804 that relates to the creditability under section 901 of the Internal Revenue Code (Code) of the United Kingdom (U.K.) Windfall Tax paid by an indirect foreign subsidiary of petitioner (U.K. Windfall Tax Issue).

8. Petitioner filed its 1997 consolidated Federal income tax return as an accrual basis taxpayer, and

except as otherwise noted herein, it used the calendar year as its taxable year.

9. Petitioner filed its 1997 consolidated Federal income tax return with the Internal Revenue Service Center in Ogden, Utah.

10. **Exhibit 2-J** is a copy of selected pages from petitioner's 1997 Form 1120, U.S. Corporation Income Tax Return. The parties reserve the right to introduce into evidence additional pages from petitioner's 1997 Form 1120.

11. On November 5, 2007, petitioner filed a timely petition with the Court for a redetermination of respondent's adjustments in the notice relating to the Street Light Issue and the Dividend Rescission Issue. Petitioner also challenged respondent's denial of petitioner's claim for refund regarding the U.K. Windfall Tax Issue.

12. At the time the petition was filed in this case, petitioner's principal place of business was in Allentown, Pennsylvania. The parties agree that decisions in this case may be reviewed by the United States Court of Appeals for the Third Circuit.

13. On January 8, 2008, respondent filed a timely answer with the Court.

II. Corporate Structure

A. Petitioner

14. In 1994, petitioner was incorporated under the laws of Pennsylvania, as an energy and utility parent holding company for petitioner's affiliated group.

15. Petitioner is a global energy company. Through its subsidiaries, petitioner provides electricity from power plants in the northeastern and western U.S.; markets wholesale or retail energy primarily in the northeastern and western portions of the U.S.; delivers electricity to approximately 4 million customers in Pennsylvania and the U.K.; and provides energy services for customers in the mid-Atlantic and northeastern U.S., as well as the U.K.

16. **Exhibit 3-J** is a copy of a chart representing petitioner's organizational structure during 1997.

17. **Exhibit 4-J** is a copy of petitioner's 1997 Form 10-K, Annual Report to the Securities and Exchange Commission.

B. PP&L

18. **Exhibit 5-J** is a copy of petitioner's 1997 annual report to shareholders.

19. During 1997, Pennsylvania Power & Light Company, a Pennsylvania corporation, was a direct subsidiary of petitioner. On September 12, 1997, the corporate name of Pennsylvania Power & Light Company was changed to PP&L, Inc. All references hereinafter to PP&L are to PP&L, Inc., or for periods before September 12, 1997, to Pennsylvania Power & Light Company. On February 14, 2000, the corporate name of PP&L, Inc., was changed to PPL Electric Utilities Corporation (PPL Electric).

20. PP&L was formed in 1920 when eight utilities - with a total of 62 steam electric and hydroelectric generating plants serving central eastern Pennsylvania—merged into a single

corporate entity called Pennsylvania Power & Light Company, headquartered in Allentown, Pennsylvania.

21. During 1997, PP&L was the operating electric utility company for petitioner's affiliated group and was engaged in, among other things, the generation, transmission, and distribution of electricity. PP&L was a regulated utility and was subject to regulation by the Pennsylvania Public Utilities Commission (PUC) and the Federal Energy Regulatory Commission (FERC). The operations of PP&L were also subject to the Occupational Safety and Health Act of 1970.

22. On December 3, 1996, then—Governor Tom Ridge signed into Pennsylvania law the Electricity Generation Customer Choice and Competition Act (66 Pa. C.S. § 2801-2812) (Customer Choice Act), requiring the deregulation of Pennsylvania's electric utility industry over a phased-in period from November 1997 through January 1/ 2001. Under this enactment, PP&L's generation business became deregulated and was separated from PP&L. PP&L's transmission and distribution business remained regulated and within PP&L (and later PPL Electric).

23. During 1997, PP&L was petitioner's principal subsidiary, with approximately 96% of the consolidated assets of petitioner's affiliated group as of December 31, 1997.

24. During 1997, PP&L provided electricity delivery service in its service territory in Pennsylvania and provided electricity supply to retail customers in that territory as a provider of last

resort. PP&L delivered electricity to approximately 1.2 million customers in a 10,000-square mile territory in 29 counties of eastern and central Pennsylvania. Its service area included 129 communities with populations over 5,000, the largest cities of which were Allentown, Bethlehem, Harrisburg, Hazleton, Lancaster, Scranton, Wilkes-Barre, and Williamsport.

25. During 1997, about 97% of PP&L's total operating revenue was derived from electric energy sales, with 33% coming from residential customers, 27% from commercial customers, 19% from industrial customers, 20% from wholesale sales, and 1% from others.

C. PMDC

26. During 1997, Power Markets Development Company (PMDC), a Pennsylvania corporation, was a direct subsidiary of petitioner. On September 12, 1997, PMDC changed its name to PP&L Global, Inc.

27. In 1997, PMDC owned 100% of the stock of PMDC International Holdings, Inc. (PMDC International). PMDC International, in turn, owned 100% of the stock of two Delaware corporations: PMDC UK Holdings, Inc. (PMDC UK Holdings) and PMDC Bristol, Inc. (PMDC Bristol), both of which were formed on June 20, 1996.

D. U.K. Subsidiaries

1. PMDC UK

28. PMDC UK Holdings owned a 20% interest in PMDC UK, a U.K. private unlimited liability

company (PMDC UK). PMDC Bristol owned an 80% interest in PMDC UK.

29. PMDC UK was incorporated on June 26, 1996, and at all relevant times herein has been classified as a foreign partnership for U.S. Federal income tax purposes.

30. **Exhibit 6-J** is a composite consisting of PMDC UK's Certificate of Incorporation and Articles of Association.

2. SWEB Holdings

31. On July I, 1996, PMDC UK acquired a 25% interest in Southern Investments UK Holdings, Limited, a U.K. private limited liability company, for $189 million. All references hereinafter to SWEB Holdings are to Southern Investments UK Holdings, Limited.

32. A Georgia corporation, Southern Electric International-Europe, Inc. (SEI), owned the remaining 75% interest in SWEB Holdings. SEI was a subsidiary of Southern Company, another major U.S. electric company.

33. SWEB Holdings was originally incorporated on May 5, 1995, as Burginhall 829 Limited.

34. **Exhibit 7-J** is a composite consisting of Certificates of Incorporation on Change of Name pertaining to the changes in name of SWEB Holdings.

3. SIUK

35. On July 11, 1995, Southern Investments UK plc (SIUK) was incorporated as a private limited liability company under U.K. law.

36. During 1997, SWEB Holdings owned 100% of the interests in SIUK.

4. SWEB

37. On April 1, 1989, South Western Electricity plc (SWEB) was incorporated as a public limited liability company under U.K. law.

38. In December 1990, SWEB was privatized by the U.K. Government.

39. In 1997, SIUK owned 100% of the interests in SWEB.

40. During 1997, SWEB was a regional utility company in southwestern England. Its principal activities at that time included the distribution and supply of electricity. It also delivered electricity to approximately 1.5 million customers in its 5,560-square-mile service area from Bristol and Bath, England to Land's End in Cornwall, England. SWEB also owned electricity generating assets.

41. Pursuant to section 898(c) (2) of the Code, SWEB elected a taxable year ending November 30th for U.S. Federal income tax purposes for all relevant years.

42. On July 31, 2001, SWEB changed its corporate name to Western Power Distribution (South West) plc.

III. Dividend Rescission Issue

A. Declaration of Dividends

43. On June 27, 1997, the Board of Directors of SWEB declared an interim dividend of £25,000,000 for payment on June 30, 1997, to the holders of ordinary shares of SWEB at the close of business on December 18, 1996. That dividend was originally recommended by the Board on December 18, 1996, and was to be payable on or before March 1, 1997, but its declaration and payment were postponed.

44. **Exhibit 8-J** is a copy of the Minutes of an Extraordinary General Meeting of SWEB held on June 27, 1997, and dated July 14, 1997.

45. On June 27, 1997, the Board of Directors of SIUK declared two interim dividends of £25,000,000, each in favor SWEB Holdings.

46. **Exhibit 9-J** is a copy of the Notice of Meeting and Ordinary Resolutions of SIUK and Agreement to Short Notice dated June 27, 1997.

47. **Exhibit 10-J** is a copy of the Minutes of an Extraordinary General Meeting of SIUK held on June 27, 1997, and dated July 14, 1997.

48. **Exhibit 11-J** is a copy of the Meeting of the Board of Directors of SIUK held on June 27, 1997.

49. On June 27, 1997, the Board of Directors of SWEB Holdings declared an interim dividend of £25,000,000 in favor of SEI (£23,486,100) and PMDC UK (£1,513,900) with a payment date of June 30, 1997 (the First Dividend). The First Dividend was declared with respect to holders of ordinary shares at the close of business on December 18, 1996, and was

attributable to earnings for the year ended December 31, 1996. The U.S. tax treatment of the First Dividend is not at issue in this case.

50. On June 27, 1997, the Board of Directors of SWEB Holdings declared an additional interim dividend of £25,000,000, in favor of SEI and PMDC UK, with a payment date of June 30, 1997 (the Second Dividend). The U.S. tax treatment of the Second Dividend is at issue in this case.

51. The Second Dividend was declared with respect to holders of ordinary shares at the close of business on June 26, 1997, and was attributable to earnings from January 1, 1997.

52. **Exhibit 12-J** is a copy of the Notice of Meeting and Ordinary Resolutions of SWEB Holdings and Agreement to Short Notice dated June 27, 1997.

53. **Exhibit 13-J** is a copy of the Minutes of an Extraordinary General Meeting of SWEB Holdings held on June 27, 1997, and dated July 14, 1997.

B. Payment of Dividends

54. **Exhibit 14-J** is a copy of the Minutes of the Board of Directors of SWEB Holdings held on June 27, 1997, and dated July 14, 1997.

55. **Exhibit 15-J** is a copy of a memorandum from Charl Oösthuizen, Treasurer of SWEB Holdings, dated June 27, 1997.

56. The Second Dividend was scheduled to be paid on June 30, 1997; however, it was not transferred until July 3, 1997.

57. On July 3, 1997, SWEB Holdings transferred £18,750,000.00 to SEI and £6,250,000.00 to an account maintained in the name of PMDC.

58. **Exhibit 16-J** is a copy of a document titled Chaps Payments from SWEB to Lloyds Bank plc, Bristol (Lloyds) dated June 30, 1997, authorizing Lloyds to transfer funds from a SWEB account to accounts maintained in the names of SEI and PMDC in satisfaction of the First Dividend.

59. **Exhibit 17-J** is a copy of a document titled Chaps Payments from SWEB to Lloyds dated July 3, 1997, authorizing Lloyds to transfer funds from a SWEB account to accounts maintained in the names of SEI and PMDC in satisfaction of the Second Dividend.

60. **Exhibit 18-J** is a copy of a portion of a bank statement for an account maintained in the name of PMDC at Citibank N.A. London (Citibank) dated July 3, 1997.

61. **Exhibit 19-J** is a copy of a letter from SIUK to SWEB dated June 30, 1997, attaching a letter from SWEB Holdings dated June 30, 1997, providing payment details for the First Dividend and Second Dividend.

C. Additional Shares

62. On July 9, 1997, the Board of Directors of SWEB Holdings authorized the share capital of the company to be increased from £200,000 to £24,866,668, divided into 18,650,001 A and 6,216,667 B Ordinary Shares of £1 each and for the Directors to allot all the unissued shares.

63. On July 9, 1997, the Directors of SWEB Holdings allotted 18,500,001 A Ordinary Shares of £1 each to SEI and 6,166,667 B Ordinary Shares of £1 each to PMDC UK. These shares have not been canceled.

64. **Exhibit 20-J** is a copy of the minutes of the Meeting of the Board of Directors of SWEB Holdings held on July 9, 1997.

65. **Exhibit 21-J** is a copy of a letter dated July 9, 1997, from SWEB Holdings to PMDC UK and SEI.

66. **Exhibit 22-J** is a copy of a letter dated July 9, 1997, from PMDC UK to the Directors of SWEB Holdings regarding application for shares.

67. **Exhibit 23-J** is a copy of a letter dated July 9, 1997, from SEI to the Directors of SWEB Holdings regarding application for shares.

68. **Exhibit 24-J** is a copy of the record of a written resolution of SWEB Holdings with attached signed resolutions, dated July 9, 1997.

D. Payments to SWEB

69. On July 10, 1997, payments of £6,166,667 and £18,500,000 were made to SWEB from accounts maintained in the names of PMDC and SEI, respectively. These payments were not the only source of cash with which to pay SWEB's U.K. Windfall Tax liability in 1997.

70. **Exhibit 25-J** is a copy of a bank statement for a Citibank account maintained in the name of PMDC dated July 10, 1997.

71. **Exhibit 26-J** is a copy of a Statement of Account for a Citibank account maintained in the name of PMDC dated July 31, 1997.

E. Miscellaneous

72. **Exhibit 27-J** is a copy of New Articles of Association for SWEB Holdings.

73. **Exhibit 28-R** is a composite consisting of a SWEB internal memorandum from Brian Harris to file dated December 18, 1997, a portion of an Inland Revenue Tax Bulletin, and a spreadsheet dated December 6, 1997. **In stipulating to Exhibit 28-R, petitioner does not accept the memorandum's statement of facts and its analysis as accurate or complete.**

74. **Exhibit 29-R** is a copy of handwritten notes that Petitioner produced in response to Respondent's formal discovery request regarding the Dividend Rescission Issue. **In stipulating to Exhibit 29-R, petitioner does not accept that the facts and analysis in the notes are accurate or complete, and cannot authenticate the context; date, purpose, or author of the notes.**

75. **Exhibit 30-R** is a copy of an e-mail, dated December 19, 1997, from James Coppola, Jr. of SEI to Messrs. Oösthuizen and Harris.

76. **Exhibit 31-J** is a copy of a document titled Rescission Agreement dated December 31, 1997. Respondent, by stipulating to this document, does not agree that it represents an agreement or an obligation to rescind the second Dividend on July 10, 1997.

77. **Exhibit 32-J** is a copy of SWEB Holdings Limited and Subsidiary Undertakings, Annual Report & Accounts, for the year ended March 31, 1998.

78. On March 14, 2001, Branch 3 of the Associate Chief Counsel (International) issued a Field Service Advice setting forth its position on the Dividend Rescission Issue. **Exhibit 33-P** is a copy of the Field Service Advice. **Respondent objects to this paragraph and exhibit as irrelevant and immaterial.**

IV. U.K. Windfall Tax Issue

A. History Preceding Enactment of Tax

1. Privatization of U.K. Companies

79. The Conservative Party won control of the U.K. Parliament in the 1979 U.K. elections.

80. The Conservative Party thereafter retained control of the U.K. Parliament between 1979 and 1997 under the leadership of Margaret Thatcher and John Major.

81. Between 1984 and 1996, the U.K. Government privatized ownership of more than 50 government-owned companies (i.e., ownership was transferred from the public to the private sector).

82. The U.K. Government privatized each of these companies that would later become subject to the U.K. windfall Tax (Windfall Tax companies) largely through a public flotation, at a fixed price offer.

83. The public flotation process involved the transfer of government-owned enterprises to new public limited companies (plcs).

84. The U.K. Government then offered shares of the new plcs in public flotations.

85. The newly privatized companies became publicly traded companies listed on the London Stock Exchange.

86. The U.K. Government hired investment banks and other advisors to assist in setting the initial share prices, structuring the offerings, and marketing the shares to investors.

87. Twelve U.K.-based regional electric companies (RECs), including SWEB, were privatized in December 1990.

88. With respect to the privatization of the government owned utilities, generally, where the floated shares were admitted to trading on the London Stock Exchange, in most cases they opened for trading at a substantial premium over the price paid for the shares by the flotation investors.

89. **Exhibit 34-P** is a copy of the prospectus dated November 21, 1990, for the flotation (i.e., public offering) of the shares of each of the twelve RECS, which is titled "The Regional Electricity Companies Share Offers." **Respondent objects to Exhibit 34-P as irrelevant and immaterial.**

90. In connection with the flotation of government-owned companies, 101,473,000 ordinary shares of SWEB's stock were offered at £2.40 per share.

91. The ordinary shares of the other eleven RECs were also offered at £2.40 per share in the course of the flotation process.

2. U.K. National Audit Office

92. Following privatization of the Windfall Tax Companies, the U.K. National Audit Office (and its Northern Ireland counterpart) published reports concerning the process employed by the various U.K. departments tasked with privatization (the NAO reports) .

93. The NAO is headed by the comptroller and Auditor General. The Comptroller and Auditor General, and the NAO, are totally independent of the U.K. Government. The Comptroller and Auditor General certifies the accounts of the Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency, and effectiveness with which departments and other bodies use their resources.

94. Exhibit 35-P is a copy of the NAO reports. Respondent objects to Exhibit 35-P as irrelevant and immaterial.

3. Regulation of the windfall Tax Companies

95. The Electricity Act of 1989 created the position of director general of electricity supply.

96. The initial director was Professor Stephen C. Littlechild.

97. Professor Littlechild held the director position from 1989-1998.

B. The Proposal and Enactment of the U.K. Windfall Tax

1. Background to U.K. Windfall Tax

98. The Labour Party campaigned on a plank in its 1997 Election Manifesto that would impose a windfall tax on utilities previously privatized under the Conservative Governments of Prime Ministers Thatcher and Major.

99. The Labour party also campaigned on a plank in its 1997 Election Manifesto that it would implement the Welfare to Work Program, a youth employment training program, and that the windfall tax on utilities would fund that program.

100. Exhibit 36-P is a copy of the Labour party's 1997 Election Manifesto. Respondent objects to Exhibit 36-P as irrelevant and immaterial.

101. In May 1996, certain members of the Labour Party's Shadow Treasury Team, which included Member of Parliament (MP) Geoffrey Robinson, began preparing the U.K. windfall Tax legislation that the Labour Party would introduce to Parliament In the likely event that it won the 1997 election.

102. Geoffrey Robinson commissioned the tax consulting firm of Arthur Andersen (the Andersen team) to assist the Labour Party's Shadow Treasury Team with the development of the U.K. Windfall Tax. The Andersen team consisted principally of Stephen Hailey, Mr. Christopher Osborne, and Dr. Christopher Wales.

103. The Andersen team was provided with four objectives: (1) examine the extent to which the privatized utilities might be able to bear an additional tax on a one-off basis (one-time); (2) consider the way in which such a tax might be structured; (3) estimate the potential yield from differing taxing mechanisms; and (4) consider the wider implications of the windfall tax proposal.

104. British Gas' profits (before tax) decreased 8% between its first full year since privatization and 1995.

105. The tax that the Andersen team devised essentially became the Windfall Tax that Parliament enacted in July 1997.

106. **Exhibit 37-R** is a copy of a PowerPoint presentation prepared and used by the Andersen Team in a presentation to Gordon Brown and the Labour Party's Shadow Treasury Team in November 1996.

107. **Exhibit 38-R** is a composite of a chain of e-mails received by Christopher Osborne between the dates of March 10, 1997, and June 2, 1997, concerning various aspects of the proposed windfall tax.

108. **Exhibit 39-R** is a copy of a document titled "Windfall Multiple" authored by a member of the Andersen Team.

109. **Exhibit 40-R** is a copy of a draft letter to MP Geoffrey Robinson from Stephen Hailey dated May 20, 1997.

110. **Exhibit 41-R** is a copy of draft document titled "Windfall Tax Arthur Andersen Submission to HM Treasury" written by the Andersen Team dated May 20, 1997.

111. **Exhibit 42-R** is a copy of a document titled "Windfall Tax A Note on Deferred Considerations" written by the Andersen Team dated May 30, 1997.

112. In the U.K., taxes are imposed by Parliament. A new tax would normally be introduced in the annual Finance Bill, which would be subject to a series of debates in Parliament. After the debates, the Finance Bill would receive Royal Assent and become law.

113. **Exhibit 43-P** is a copy of the full text of the Budget Speech by Chancellor of the Exchequer Gordon Brown on July 2, 1997, announcing the Windfall Tax. **Respondent objects to Exhibit 43-P as irrelevant and immaterial.**

114. When the Labour Party came into power in the U.K. Government in 1997, Geoffrey Robinson, the U.K. Labour Party's Paymaster General from May 4, 1997, to December 23, 1998, was the responsible Minister with respect to the U.K. Windfall Tax.

115. **Exhibit 44-J** is a copy of the U.K. Inland Revenue (Inland Revenue) announcement dated July 2, 1997, about the proposed U.K. Windfall Tax.

116. **Exhibit 45-P** is a copy of a publication titled "Explanatory Notes Summer Finance Bill 1997—HM TREASURY—July 1997." **Respondent objects to Exhibit 4S-P as irrelevant and immaterial.**

117. On July 31, 1997, the Finance (No.2) Act 1997 received Royal Assent and became law. The Finance (No.2) Act 1997 (the Act) contained the U.K. Windfall Tax. **Exhibit 46-J** is a copy of the Act.

118. The U.K. Windfall Tax provisions appear in Part I of the Act. The U.K. Income Tax and Corporation Tax provisions appear in Part III of the Act.

119. In the Finance Act 2000, Parliament introduced a "Tonnage Tax" as an alternative method of computing the income tax applicable to shipping companies. The Tonnage Tax was included in the same part of the Act as the U.K. Income Tax, Corporation Tax, and Capital Gains Taxes.

120. **Exhibit 47-R** is a copy of a book titled "The Unconventional Minister: My Life Inside New Labour," written by Geoffrey Robinson, published in 2000. **Petitioner does not agree that Chapter 6 of Geoffrey Robinson's book in its entirety is a true, accurate, or complete description of the enactment and development of the U.K. Windfall Tax, and Petitioner does not necessarily agree to the truth of the assertions within Exhibit 47-R and such assertions may be rebutted or corroborated by additional evidence.**

121. **Exhibit 48-P** is a composite of Parliamentary debates with respect to the passage of the U.K. Windfall Tax from Hansard (Hansard Debates). **Respondent objects to Exhibit 48-P as irrelevant and immaterial.**

122. In connection with the enactment and development of the U.K. Windfall Tax, the Labour Party sought advice as to certain legal issues in relation to the Party's proposed Windfall Tax. **Exhibit 49-P** is a copy of a Joint Opinion, dated February 12, 1997, issued by the The Honourable Michael J. Beloff QC, and Rabinder Singh.

2. Analysis of the U.K. Windfall Tax Statute

123. Ultimately, 32 of the privatized companies were subject to the U.K. Windfall Tax, each of which was a utility company that provided telephone, gas, electricity, water, sewer, airport, or rail services.

124. The names of the 32 Windfall Tax Companies, listed alphabetically, were as follows: (a) Anglian Water plc; (b) BAA plc; (c) British Energy plc; (d) British Gas plc;1 (e) British Telecommunications plc; (f) East Midlands Electricity plc; (g) Eastern Electricity plc; (h) London Electricity plc; (i) Manweb plc; (j) Midlands Electricity plc; (k) National Power plc; (l) North West Water Group plc; (m) Northern Electric plc; (n) Northern Ireland Electricity plc; (o) Northumbrian Water Group plc; (p) NORWEB plc; (q) PowerGen plc; (r) Railtrack Group plc; (s) Scottish Hydro-Electric plc; (t) Scottish Power plc; (u) SEEBOARD plc; (v) Severn Trent plc; (w) South Wales Electricity plc; (x) SWEB; (y) Southern Electric plc; (z) Southern Water plc; (aa) South West Water plc; (bb) Thames Water plc; (cc)

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[1] In February 1997, British Gas plc was split into two corporations, BG plc and Centrica plc, each of which paid a portion of the Windfall Tax that would have been owed by British Gas plc.

Welsh Water plc; (dd) Wessex Water plc; (ee) Yorkshire Electricity Group plc; (ff) Yorkshire Water plc. Some of these companies have since changed their names.

125. The U.K. Windfall Tax was a compulsory payment pursuant to the U.K. Parliament's authority to levy taxes.

126. No part of the U.K. Windfall Tax was paid in exchange for any specific economic benefit.

127. The U.K. windfall Tax was not a penalty, fine, interest, or similar obligation.

128. No part of the U.K. Windfall Tax was refundable in the U.K. or creditable against the regular U.K. corporate income tax.

129. No subsidy was given to a taxpayer as a result of that taxpayer's being subject to and paying the U.K. Windfall Tax.

130. Liability for the U.K. Windfall Tax was not dependent on the availability of a credit for the U.K. Windfall Tax against income tax liability of any other country.

131. Part I Section 1(1) of the Windfall Tax statute provides: "Every company which, on 2nd July 1997, was benefiting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall."

132. Under Section 1(2), the statute provides that the "[w]indfall tax shall be charged at the rate of 23 per cent.

133. Section 1(3) provides that "windfall" is quantified under Schedule 1 of the Act.

134. Under Schedule 1, the amount of the "windfall" is the excess (if any) of (1) "the value in profit-making terms of the disposal made on the occasion of the company's flotation," over (2) "the value which for privatisation purposes was put on that disposal."

135. "Value in profit-making terms" is defined in Schedule 1 as the average annual profit for a company's initial period multiplied by the applicable price-to-earnings ratio of nine.

136. The price-to-earnings ratio of nine applied to all of the companies subject to the Windfall Tax for purposes of the "value in profit-making terms" calculation.

137. "Initial period" encompasses up to the first four years after privatization, unless such initial period would have ended on or after April 1, 1997.

138. The number of days in a Windfall Tax Company's initial period varied depending on when the Windfall Tax Company was privatized.

139. Where a Windfall Tax Company's initial period would have ended on or after April 1, 1997, that company's initial period began on the date of its privatization and ended on the last day of the last full financial year to end before April 1, 1997.

140. The Windfall Tax Companies were privatized on different dates.

141. "Value ... for privatisation purposes" is "produced by multiplying the institutional price by

the number of shares comprised in the ordinary share capital of the company at the time of its flotation" (to be known as Flotation Value or FV).

142. A Windfall Tax Company's Flotation Value was not based on what the shares *actually* sold for at privatization, but on the highest fixed price at which the shares were offered.

143. "Institutional price" is the highest fixed price per share at which publicly-owned shares in the company were offered on flotation.

144. According to a U.K. Inland Revenue Announcement dated July 2, 1997 (see **Exhibit 44-J**), the applicable price-to-earnings ratio of nine approximated the lowest average price-to-earnings ratio of all the Windfall Tax Companies during the relevant periods, grouped by sector.

145. Since the Windfall Tax Companies were privatized over a period of more than 12 years, the formula in the Act for calculating "value in profit-making terms" of each company may include profits arising in different years, depending on the date that the windfall Tax Company was privatized.

146. Thirty-one of the 32 windfall Tax Companies had a U.K. Windfall Tax liability. One of the 32 Windfall Tax Companies (British Energy plc) did not have a U.K. Windfall Tax liability. No Windfall Tax Company had a Windfall Tax liability that exceeded its total profits over its initial period.

147. Twenty-nine of the 32 Windfall Tax Companies had initial periods of four full financial years. Twenty-seven of the 32 Windfall Tax

Companies had initial periods consisting of 1,461 days. The remaining two of the 32 Windfall Tax Companies (National Power plc and PowerGen plc) had initial periods consisting of 1,456 days and 1,463 days, respectively.

148. Three of the 32 windfall Tax Companies (Northern Ireland Electricity plc, Railtrack Group plc, and British Energy plc) had initial periods of less than four full financial years (consisting of 1,380 days, 316 days, and 260 days, respectively).

149. Profit for a Windfall Tax Company's initial period was equal to the company's "profit on ordinary activities after tax," as determined under U.K. financial accounting principles and standards, and as shown in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act 1985, as amended (Companies Act).

150. Average annual profit used in the "value in profit-making terms" calculation is quantified by dividing "the total profits for the company's initial period," by "the number of days in the company's initial period," and then multiplying that figure by 365. This produces "average annual profit" for a 365-day year during the company's initial period. Thus, "average annual profit" was produced by the following formula:

$$A = 365 \times (P \div D)$$

Where:

A = the average annual profit for the Windfall Tax Company's initial period;

P = the total profit for a Windfall Tax Company's initial period; and

D = the number of days in the windfall Tax Company's initial period.

151. Where 85 percent or less of the ordinary shares of the Windfall Tax Company were offered for sale at flotation, both the "value in profit-making terms" and the flotation value were proportionally reduced by reference to the percentage of shares actually offered for sale (Disposal percentage).

152. In July 1997, the enactment date of the Windfall Tax, the initial period, the number of days in the initial period, the highest fixed price at which the shares were floated, and the number of shares floated were predetermined for each of the Windfall Tax Companies. The average annual profit used to calculate the "value in profit-making terms" of all of the Windfall Tax Companies was known prior to the enactment of the Windfall Tax, with the exception of one Windfall Tax Company's profits (i.e., SWEB) for one of its four years within its initial period.

3. Algebraic Reformulations

153. In equation form, the complete U.K. Windfall Tax statutory formula, as provided by Part I of, and Schedule 1 to, the Act, was as follows:

$$\text{U.K. Windfall Tax} = 23\% \times [\{(365 \times (P \div D)) \times 9\} - FV]$$

154. The base upon which the 23% Windfall Tax was imposed also can be expressed as: "Value in profit-making terms" less Flotation value x 23%.

155. For the 27 Windfall Tax Companies with initial periods of four full financial years consisting of 1,461 days, the language of the Act that provides for the amount of their U.K. Windfall Tax liability can be expressed by the following equation:

U.K. Windfall Tax = 23% x [{(365 x (P ÷ 1,461)) x 9} - FV]

156. The following equation produces the same amount of Windfall Tax for the 27 Windfall Tax Companies with initial periods consisting of 1,461 days as the equation in paragraph 155 above:[2]

U.K. windfall Tax = 23% x [{(P ÷ 4) x 9} - FV)]

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

157. The following equation produces the same amount of Windfall Tax for the 27 Windfall Tax Companies with initial periods consisting of 1,461 days as the equation in paragraph 156 above:

U.K. Windfall Tax = (23% x (9 + 4)) x [P - {(4 ÷ 9) x FV}]

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate

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[2] For simplicity, here and in paragraph 157 below, the number "4" represents 1461 ÷ 365 or approximately 4.0027397.

application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

158. The following equation produces the same amount of Windfall Tax for the 27 Windfall Tax Companies with initial periods consisting of 1,461 days as the equation in paragraph 157 above:[3]

U.K. Windfall Tax = 51.71% x {P - (44.47 x FV)}

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

159. The following equation produces the same amount of Windfall Tax as the equation in paragraph 158 above where "P_{1-4} " are the profit for each one of the four financial years during the initial period for the 27 Windfall Tax Companies with initial periods of four full financial years consisting of 1,461 days, provided that where a "P" value for a given year is less than "(11.11% x FV)," 51.71% of the resulting negative number would reduce the U.K. Windfall Tax attributable to the other years in the initial period:[4]

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[3] For simplicity, the percentage "44.47%"1 represents (1461 ÷ 365) ÷ 9 or approximately 0.4447489; here and in paragraph 159 below, the percentage "51.71%" represents {9 ÷ (1,461 ÷ 365)} x 23% or approximately 0.5171458.

[4] For simplicity, the percentage "11.11%" represents {(1461 ÷ 365) ÷ 9 ÷ (1461 ÷ 365) or approximately 0.1111111; similarly, the percentage "11.14%" represents {(1461 ÷ 365) ÷9 ÷ (1461 ÷ 366) or approximately 0.1114155. This coefficient takes on a

U.K. Windfall Tax = 51.71% x {P_1 (11.11% x FV)}
+ 51.71% x {P_2 - (11.11% x FV)}
+ 51.71% x {P_3 - (11.11% x FV)}
+ 51.71% x {P_4 - (11.14% x FV)}

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

160. Neither the Act, Schedule 1 of the Act, nor the U.K. Windfall Tax Return requires the calculation of a Windfall Tax due on a year-by-year basis.

161. Five Windfall Tax Companies had initial periods longer than or shorter than 1,461 days. Accordingly, different alternative equations would have to be developed to produce an amount of Windfall Tax equal to that produced under the Windfall Tax statutory formula under the Act as applied to those Windfall Tax companies. These different equations would require different tax rates to be applied to those windfall Tax Companies, based not on the level of their profits but on the length of the initial period.

162. For Powergen plc, a company subject to the windfall Tax with an initial period consisting of 1,463 days, the language of the Act providing for the

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value of 11.14% instead of 11.11% on the leap year (Shown to be Year 4, for demonstrative purposes)

amount of its U.K. windfall Tax liability can be expressed by the following equation:

U.K. Windfall Tax = 23% x [{(365 x (P ÷ 1,463)) x 9} - FV]

163. The following equation produces the same amount of Windfall Tax as the equation in paragraph 162 above:[5]

U.K. Windfall Tax = 51.64% x {P - (44.54% x FV)}

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

164. For National Power plc, a company subject to the Windfall Tax with an initial period consisting of 1,456 days, the language of the Act providing for the amount of its U.K. Windfall Tax liability can be expressed by the following equation:[6]

U.K. Windfall Tax = 23% x [{(365 x (P ÷ 1,465)) x 9} - FV]

165. The following equation produces the same amount of Windfall Tax as the equation in paragraph 164 above:

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[5] For simplicity, the percentage "44.54%" represents (1463 ÷ 365) ÷ 9 or approximately 0.4453576, and the percentage "51.64%" represents {9 ÷ (1463 ÷ 365)} x 23% or approximately 0.5164388.

[6] For simplicity, the percentage "44.32%" represents (1456 ÷ 365) ÷ 9 or approximately 0.4432268, and the percentage "51.89%" represents {9 ÷ (1456 ÷ 365)} x 23% or approximately 0.5189217.

U.K. Windfall Tax = 51.89% x {P - (44.32% x FV)}

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

166. For Northern Ireland Electricity plc, a company subject to the Windfall Tax with an initial period consisting of 1,380 days, the language of the Act providing for the amount of its U.K. Windfall Tax liability can be expressed by the following equation:

U.K. Windfall Tax = 23% x [{(365 x (P ÷ 1,380)) x 9} - FV)

167. The following equation produces he same amount of Windfall Tax as the equation in paragraph 166 above:[7]

U.K. Windfall Tax = 54.75% x {P - (42.01% x FV)}

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act. Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

168. For Railtrack Group plc, a company subject to the Windfall Tax with an initial period consisting of 316 days, the language of the Act providing for the

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[7] For simplicity, the percentage "42.01%" represents (1,380 ÷ 365) ÷ 9 or approximately 0.4200913, and the percentage "54.75%" represents {9 ÷ (1,380 ÷ 365)} x 23% or approximately 0.5474999.

amount of its U.K. Windfall Tax liability can be expressed by the following equation:

U.K. Windfall Tax = 23% x [{(365 x (P ÷ 316)) x 9} - FV]

169. The following equation produces the same amount of Windfall Tax as the equation in paragraph 168 above:[8]

U.K. Windfall Tax = 239.10% x {P - (9.62% x FV)}

Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act.

Furthermore, Respondent objects to this stipulation as irrelevant and immaterial.

170. Railtrack Group plc's profits for its financial year ended March 31, 1997, its total profits for its initial period, and its U.K. windfall Tax liability were £292 million, £252.8 million, and £156.0 million respectively.

4. Companies Act

171. The Windfall Tax statute provided that the profit figures used in calculating the "Value in profit-making terms" were to be taken from the published accounts and reports that the Windfall Tax Companies filed pursuant to Section 242 of the U.K. companies Act 1985 (the Companies Act).

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[8] For simplicity, the percentage "9.62%" represents (316 ÷ 365) ÷ 9 or approximately 0.0961948, and the percentage "239.10%" represents {9 ÷ (316 ÷ 365)} x 23% or approximately 2.3909808.

172. The Companies Act, as modified by subsequent published guidance, prescribed U.K. financial accounting principles and standards for the preparation of financial statements for U.K. companies.

173. Schedule 4 of the Companies Act specifies the form and content for a company's profit and loss accounts. **Exhibit 50-J** consists of copies of Schedule 4 of the Companies Act 1985 and amendments to Schedule 4 and Schedule 4A in the Companies Act 1989.

174. Under Part I of Schedule 4, companies may choose one of several formats for profit and loss accounts.

175. The Companies Act, as modified by subsequent published guidance, required companies to prepare their financial accounts so as to give a "true and fair view" of their financial affairs.

176. Part II of Schedule 4 provides certain accounting principles and rules to be followed in preparing company accounts.

177. **Exhibit 51-J, Exhibit 52-J, Exhibit 53-J,** and **Exhibit 54-J,** are copies of SWEB's audited financial statements and accountant's reports for its financial years ended March 31, 1992, 1993, 1994, and 1995, respectively, which were filed with the U.K. Registrar of companies, also known as "Companies House."

C. SWEB's Payment of the U.K. Windfall Tax

178. SWEB was one of the 12 regional electricity companies that the U.K. Government privatized in

December 1990, and SWEB consequently was one of the 32 Windfall Tax Companies subject to the U.K. Windfall Tax.

179. Prior to filing its Windfall Tax return, SWEB restated its published profit account for its year ended March 31, 1995. That undertaking required filing a restated profit account with the U.K. Registrar of Companies and mailing a copy of that restated profit account to each person who was a shareholder of SWEB during its year ended March 31, 1995.

180. In 1997, a "one-off" (one time) U.K. Windfall Tax in the amount of approximately £90,419,265 was reported by SWEB on its Windfall Tax return. That liability was calculated based on its restated profit and loss accounts for its year ended March 31, 1995.

181. The Financial Reporting Review Panel accepted SWEB's restated profit and loss accounts.

182. The U.K. Windfall Tax was due in two installments, the first installment due by December 1, 1997, and the second installment due by December 1, 1998.

183. Inland Revenue challenged SWEB's ability to restate its 1995 reported profits.

184. **Exhibit 55-P** is a copy of a letter from Inland Revenue to SWEB dated November 18, 1997

185. **Exhibit S6-P** is a copy of a letter from Inland Revenue to SWEB dated November 24, 1997.

186. **Exhibit 57-P** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to Inland Revenue dated November 27, 1997.

187. **Exhibit S9-P** is a copy of a letter from Inland Revenue to SWEB dated December 9, 1997.

188. **Exhibit 59-P** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to Inland Revenue dated January 27, 1998.

189. **Exhibit 60-P** is a copy of a letter from Inland Revenue to SWEB dated February 9, 1998.

190. **Exhibit 61-P** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to Inland Revenue dated March 23, 1998.

191. **Exhibit 62-P** is a copy of a letter from Inland Revenue to SWEB dated April 17, 1998, enclosing a copy of a letter from Inland Revenue to the Financial Reporting Review Panel dated April 17, 1998 and Inland Revenue's report with respect to SWEB.

192. **Exhibit 63-P** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to the Financial Reporting Review Panel dated April 23, 1998.

193. **Exhibit 64-p** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to the Financial Reporting Review Panel dated August 7, 1998.

194. **Exhibit 65-P** is a copy of a letter from the Financial Reporting Review Panel to SWEB dated September 16, 1998.

195. **Exhibit 66-P** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to the Financial Reporting Review Panel dated September 30, 1998

196. **Exhibit 67-P** is a copy of a letter from Mr. Charl Oösthuizen of SWEB to the Financial Reporting Review Panel dated October 12, 1998.

197. **Exhibit 68-P** is a copy of the Financial Reporting Review Panel's report dated October 16, 1998, relating to the restatement of profit and loss accounts by SWEB.

198. **Exhibit 69-P** is a copy of a letter from Inland Revenue to SWEB dated December 15, 1998, attaching the Notice of Windfall Tax Assessment.

199. SWEB's U.K. Windfall Tax liability was timely paid on December 1, 1997, and December 1, 1998, in the following amounts:

Payment Date	Amount Paid (£)
December 1, 1997	45,209,632.50
December 1, 1998	45,209,632.50
Total	90,419,265.00

200. **Exhibit 70-J** is a copy of SWEB's windfall Tax return which it filed with Inland Revenue on November 7, 1997. Components of the tax computation for SWEB are described in the following paragraphs. SWEB did not file an additional or amended Windfall Tax return in connection with the restatement of its profit and loss accounts.

201. Initial period: SWEB's initial period was four full financial years (i.e., its financial years ended March 31, 1992, 1993, 1994, and 1995) I which consisted of 1,461 days.

202. Total profit for initial period: SWEB's "profit on ordinary activities after tax" as determined under U.K. financial accounting principles and standards

was £62,300,000 for financial year ended March 31, 1992; £77,700,000 for financial year ended March 31, 1993; £92,900,000 for financial year ended March 31, 1994; and £73,300,000 for financial year ended March 31, 1995. Those figures are shown on SWEB's U.K. Windfall Tax return **(Exhibit 70-J).** Thus, SWEB's total profit for its initial period was £306,200,000.

203. Average annual profit: SWEB's average annual profit for its initial period was £306,200,000 in total profit divided by 1,461 days times 365 days, or £76,497,604.

204. Value in profit-making terms: SWEB's value in profit-making terms was £688,478,439 (i.e., £76,497,604 average annual profit for its initial period multiplied by nine).

205. Flotation value: SWEB's flotation value was £295,351,200 (i.e., 123,063,000 ordinary shares multiplied by £2.40 per share).

206. U.K. Windfall Tax taxable amount was £393,127,239 (i.e., £688,478,439 value in profit-making terms minus £295,351,200 flotation value).

207. U.K. Windfall Tax liability: The amount of SWEB's U.K. windfall Tax liability was £90,419,265 (i.e., £393,127,239 U.K. windfall taxable amount times 23%).

D. SWEB's U.K. Corporation Tax Liability

208. The table below shows SWEB's profits chargeable to U.K. Corporation Tax and its U.K. Corporation Tax Liability for its years ended March

31, 1992, March 31, 1993, March 31, 1994, and March 31, 1995:

Year Ended	Profits chargeable to U.K. Corporation Tax	U.K. Corporation Tax liability
March 31, 1992	£39,684,324	£13,095,827
March 31, 1993	£36,516,589	£12,050,474
March 31, 1994	£62,792,325	£20,721,467
March 31, 1995	£71,318,277	£23,535,031

E. Petitioner's Treatment of the U.K. Windfall Tax as a Creditable Tax

209. The calculation of U.K. Corporation Tax begins with a company's profit on ordinary activities before tax as determined under U.K. financial accounting principles and standards, as shown in the company's profit and loss accounts prepared for U.K, Companies Act purposes which are then adjusted to determine taxable income for U.K. Corporation Tax purposes.

210. On May 18, 2000, Petitioner filed a refund claim with the Internal Revenue Service for its 1997 tax year that seeks a tax refund based on treatment of the U.K. Windfall Tax as a creditable tax under section 901 of the Code.

211. The refund claim shows a reduction of Petitioner's 1997 tax liability as a result of treating

the U.K. Windfall Tax as a creditable tax under section 901 of the Code. For 1997, the reduction in Petitioner's tax liability occurs as a result of treating a distribution by SWEB to PMDC UK as a non-taxable dividend and the elimination of SWEB's reported subpart F income for 1997.

212. Attached as **Exhibit 71-J** is a copy of a letter from John H. Yardley of Petitioner's Tax Department to Mr. Ronald L. Koder, International Examiner, dated May 18, 2000, making the claim for refund.

213. In the Notice of Deficiency, Respondent determined that the claim for refund is not allowable because the U.K. Windfall Tax is not a creditable tax within the meaning of section 901 of the Code, or under Article 23(1) of the Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland.

214. SWEB was a controlled foreign corporation within the meaning of section 957(a) of the Code at all times while owned indirectly by Petitioner's consolidated group.

F. Other Excess Profits Taxes

215. From time to time (e.g., the World War I, World War II, and Korean War eras), the U.S. Congress has enacted annually-imposed excess profits taxes as additions to the corporate income tax. **Respondent objects to this paragraph as irrelevant and immaterial.**

216. **Exhibit 72-P** is a copy of the Excess Profits Tax Act of 1917 (Title II at 39 Stat. 1000). **Respondent objects to Exhibit 72-P as irrelevant and immaterial.**

217. **Exhibit 73-P** is a copy of the Excess Profits Tax Act of 1940 (Second Revenue Act of 1940, ch. 757, sections 710-752, 54 Stat. 1008). **Respondent objects to Exhibit 73-P as irrelevant and immaterial.**

218. Exhibit 74-P is a copy of the Excess Profits Tax Act of 1950 (Pub. L. 81-909). Respondent objects to Exhibit 74-P as irrelevant and immaterial.

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EXHIBIT 35-P

THE SALE OF THE TWELVE REGIONAL ELECTRICITY COMPANIES, REPORT BY THE COMPTROLLER AND AUDITOR GENERAL NATIONAL AUDIT OFFICE

MAY 6, 1992

[Table of Contents omitted in printing this appendix]

Summary and conclusions

1 In December 1990 the Secretary of State for Energy sold the twelve regional electricity companies in England and Wales. The Department of Energy (the Department) estimated that gross proceeds will amount to some £7.9 billion, payable in two forms: nearly £5.1 billion, in instalments, from the sale of the shares and some £2.8 billion from staged debt repayments. Since the sale the Department have been merged with the Department of Trade and Industry who are now responsible for the matters dealt with in this report.

2 This was one of the largest sales since 1979. It was also one of the most complex, involving the simultaneous disposal of all the Government's shareholdings in the twelve regional electricity companies. who distribute and sell electricity to customers in England and Wales. The sale introduced an entirely new sector to the London Stock Exchange. It followed a radical restructuring of the electricity industry's

organisation and its commercial and regulatory arrangements. It was the first of an ambitious series of three sales planned in the British electricity sector, to be followed by the sale of National Power and PowerGen, who generate electricity in England and Wales, and the Scottish companies ScottishPower and Hydro-Electric.

3 The twelve electricity companies were floated on the London Stock Exchange by means of a fixed price offer. Shares totalling some 2.1 billion were offered for sale at £2.40 each, payable in three instalments.

4 The Government's overriding objective was to complete the sale of the electricity industry during the lifetime of the Parliament. Within that overriding objective, the Department sought: to maximise net proceeds: to widen and deepen share ownership among individuals: to achieve the overall recognition that the sale of the regional companies had been a success; and to achieve a modest premium over the issue price following the start of share dealings.

5 This report sets out the results of a National Audit Office examination of how far the Department achieved their objectives for the sale and how they controlled its costs. During the course of their work, the National Audit Office examined Departmental papers, held discussions with Departmental officials and advisers, and consulted the Chairmen and senior executives of three of the companies. The National Audit Office were assisted in their

work by Hambros Bank Limited and SRU Limited, strategic market consultants.

Achievement of objectives

6 The National Audit Office's main findings and conclusion are:

On the overriding objective of completing the sale to timetable

(a) The Department completed the sale of the regional electricity companies by their December 1990 target, paving the way for the generating companies to be sold in March 1991 and the Scottish companies by June 1991 (paragraphs 2.2 to 2.6).

On maximising net proceeds

Method of sale

(b) In floating the companies, the Department took appropriate steps to identify and evaluate a variety of options that might help maximise net proceeds, Introducing major innovations into the chosen method of sale would not have been without risk to achieving this objective, given the novelty of the companies and the considerable uncertainty of the market at the time of the sale (paragraphs 2.9 to 2.16).

(c) The National Audit Office recognise these uncertainties but. with the benefit of hindsight. note that if a back-end tender—which the Department succeeded in implementing for the first time in the subsequent sale of the generating companies—could have been successfully introduced in this sale, it would

have enabled the Department to share in the increase in the value of the companies which, in the event, took place during the offer period. In the circumstances at the time of the sale, however, the Department accepted the strong recommendation of their advisers that introducing such measures would have entailed risks to the success of the sale, and to proceeds, outweighing the potential gain.

Valuation of the assets

(d) The approach adopted by the Department to the valuation of the companies' assets was reasonable in the circumstances of this sale (paragraphs 2.20 to 2.23).

Clawback

(e) The Department introduced provision for clawback on gains arising from the disposal of land and buildings between 31 March 1990 and 31 March 2000 (paragraphs 2.24 and 2.25).

(f) The Department also considered but did not introduce provision for clawback on profits. The view of the Department and their advisers was, and remains, that the existence of such a provision would have altered the basis on which the negotiations on dividends took place. Their view is that. if profit claw back had been introduced, they would have had a much reduced chance of achieving the levels of dividend that they sought and obtained, and an increased chance of having to sell the companies at a less advantageous yield, and that either of these factors would have had more of a negative

impact on proceeds than the potential profits to be clawed back (paragraph 2.26).

(g) Overall profit outturn for 1990-91 was 22 per cent (£214.4 million) higher than forecast. The Department note that dividends, which are the main determinant of proceeds, were however set on the basis of underlying profit performance not on the first year profit forecasts, which were necessarily set on a cautious basis (paragraphs 2.27 to 2.30). In view, however, of the limited track record of the companies and the correspondingly cautious basis on which forecasts for the first year were made, the National Audit Office and their advisers, Hambros, believe that it would have been appropriate for the Department to have explored in detail with their advisers whether higher net proceeds might have been achievable by making provision for clawback of a proportion of at least some part of any profits exceeding the forecast for that first year. Even such a limited clawback would have called for a careful assessment as to whether a provision along these lines could be implemented without greater negative impact either on the dividends which the companies would be prepared to offer, or on the dividend yield which investors would be prepared to accept: and of course for careful presentation to companies and investors. The assessment of the Department and their advisers is that any benefit from such a provision would, in this sale, have been significantly outweighed by the loss of proceeds likely to have resulted from lower

dividends or higher yield, or a combination of both.

Sale of all the shoreholding

(h) The Department kept open the possibility of selling only part of the Government's shareholding (60 per cent), in case there was a severe deterioration in market conditions. In the event, however, they proceeded with a 100 per cent sale because they saw it as offering the best balance of risk in the circumstances (paragraphs 2.38 to 2.41).

Pricing the offer

(i) The Department set the fully paid value of the shares at nearly £5.2 billion. In so doing, they sought the best price they thought they could get in negotiating the sale of these new companies during a period of unsettled market conditions (paragraphs 2.46 to 2.52),

(j) Following the start of dealings, the market valued the shares at £6.3 billion. The Department's advisers attribute this to upward movements in the stock market between the time the offer had to be priced, when mar ket conditions were uncertain, and the start of dealings (paragraphs 2.53 to 2.60).

(k) The National Audit Office's consultants, Hambros, agree that most of the increase in the value of the electricity companies above the Department's target premium was attributable to the upward movements in the market generally, and in particular to the increase in

gas and water shares. The causes of these upward movements are likely to remain unclear because they flowed from the investment decisions of a large number of individual institutions.

On widening and deepening share ownership

Targets/planning assumptions

(l) The Department succeeded in meeting their broad planning assumption for the number of individuals who might register their interest in the sale. The Department's planning assumptions about the minimum level of subscription they saw as desirable, and their initial estimate of the number of applications to be processed, were however exceeded (paragraphs 2.65 to 2.69).

(m) The Department considered, but did not adopt, formal target ranges either for the total number of applications or for the proportion relating to new shareholders. This was because, while they designed many features of the offers to attract the smaller and newer investor, they and their advisers concluded that the actual outcome would be largely determined by market conditions and media endorsement, which were too uncertain to predict with any degree of confidence. The Department took the view that such targets would be artificial and possibly counterproductive. There were. in the event, 12.75 million applications, and research indicated that the sale may have attracted

around 1.5 to 1.8 million new shareholders (paragraphs 2.70 to 2.73). While recognizing these factors, it would, in the opinion of the National Audit Office, have nevertheless been appropriate for the Department to have set broad target ranges for numbers of applications and new shareholders, and taken these also into account in pursuing their objective of widening and deepening share ownership.

Monitoring the outcome

(n) The National Audit Office believe that, building on the research they had conducted before the sale, the Department could usefully have extended the market research carried out following the sale, to verify the key factors influencing the buying and selling decisions of individuals in the circumstances of this sale. While such decisions have generally been shown in the past to have been heavily influenced by the expected or actual standing of the relevant share prices in the market, this might have been of assistance to departments in establishing broad targets in relation to subsequent sales (paragraphs 2.73 to 2.75).

On achieving overall recognition of success

(o) The Department's objective of achieving overall recognition that the sale had been a success was directed towards creating favourable perceptions and conditions for the sale, and hence for the subsequent electricity sales (paragraphs 2.77 and 2.78). It would be difficult to construct precise measures against

which to assess the achievement of this objective.

(p) Nevertheless, the high numbers of applications and levels of subscriptions. against the background of media endorsement of the sale, and the triggering of the reallocation of shares from institutional and overseas investors to individual investors, are of the attactiveness of the offer to individuals, Limited adverse comment from the media on certain aspects of the sale, for example, the reduced levels of share allocations which many applicants received as a result of the high number of applications, does not appear to have had a negative impact on the successful carrying through of the subsequent electricity sales (paragraphs 2.79 and 2.80).

On achieving a modest premium

(q) The premium at which the shares were traded when dealings began averaged 49 pence, by comparison with the Department's target of 15 pence. Of the 49 pence premium, 30 pence was attributable to the general upward movements in the market which began after the offer was priced. The size of the balance (19 pence) suggests that the Department's target of 15 pence (6 per cent of the full paid price) was perhaps ambitious in the circumstances of this sale (paragraphs 2.81 to 2.83).

Controlling the costs of the sale

7 The National Audit Office's main findings and conclusion are:

Financial control and project management

(a) The Department applied sound financial guidelines for the operational requirements of the sale, and applied appropriate procedures for the selection of their advisers (paragraphs 3.2 and 3.3).

Incentives for individual investors

(b) The Department offered incentives, estimated to cost some £61 million, that were broadly in line with those available in the water sale. In doing so the Department sought to meet four aims: first, to establish a cost-effective means of achieving an attractive yield on the shares; second, to encourage registrations and subsequent applications; third, to encourage individuals to invest in their local companies; and fourth, in the process to avoid adverse media criticism which might deter investors. Market research carried out prior to the incentives being decided revealed no firm evidence that the presence of incentives would increase the total number of investors, but indicated some risk to the marketing of the sale-albeit difficult to quantify-of adopting materially less generous incentives (paragraphs 3.7 to 3.10).

(c) In the opinion of the National Audit Office it would have been appropriate for the

Department to have carried out further market research, between settling the broad structure of the incentives package in July and the announcement of the details in October, aimed at clarifying some of the uncertainties which their researchers had identified as to what types and value of incentives might be needed in the circumstances of the electricity sale, If the results of such research and analysis had pointed to lower incentives than had been offered in previous sales. the Department would of course have needed to consider, with their marketing advisers, how best to present this to the media, in order to avoid possible adverse criticism and so to secure a successful sale which maximised net proceeds, and to have balanced against this the risk to the success' of the offer from any uncertainties they felt might remain in this area (paragraphs 3.11 and 3.12).

Incentives for employees

(d) The Department provided employee incentives, estimated to cost some £51 million, which were intended to fulfill the Government's commitment to offer employees a stake in their industry on attractive terms. These incentives were more generous than those offered in previous large privatisations because the Department concluded, following negotiations with the employees' trade union representatives and with the management of the companies, that it would have been unrealistic to have offered materially less generous terms (paragraphs 3.13 to 3.15).

Underwriting commissions

(e) The Department achieved through a tender process an overall rate of 0.17 per cent of the share price for primary underwriting. This was one of the lowest rates so far for a major sale of Government shareholdings (paragraph 3.16).

General conclusion

8 A number of previous privatisations had proceeded on the basis of a partial sale. Having considered whether they should follow this course, which all their main financial advisers strongly recommended against, the Department went ahead with a 100 per cent sale. This was on the grounds that not to have done so might have jeopardised the success of the sale and the Government's overriding objective of completing all three electricity sales to a demanding timetable. Nevertheless, the novelty of the industry, and of the companies, and the uncertain market conditions at the time of sale, arising out of the deepening recession, the Gulf crisis, and the Conservative leadership election, made it particularly difficult for the Department to price the issue.

Recommendations

9 In the National Audit Office's view departments should, when pursuing objectives set by the Government:

- continue to give careful consideration to retaining a substantial minority shareholding to be sold at a future date when market

conditions may be more favourable and when a longer track record will be available, rather than selling all the Government's shareholdings at a time of market uncertainty;

- continue to draw on the experience of such sales in appraising the possible benefits and risks of introducing innovations to sale methods and clawback provisions;
- carry out further research before the sales aimed at resolving current uncertainties over the likely impact of incentives on the decisions of individual investors;
- carry out further research following the sales to ascertain what factors (including the role of the media and market movements) influenced individual investors to apply for shares, and subsequently to sell or retain them.

* * *

Part 2: Achievement of objectives

2.1 This part of the report examines how far the Department were successful in achieving their sale objectives:

(i) to complete the sale to timetable:

(ii) to maximise net proceeds:

(iii) to widen and deepen share ownership;

(iv) to achieve overall recognition that the sale had been a success:

(v) to achieve a modest premium.

Completing the sale to timetable

2.2 The Government's overriding objective was to complete the sale of the regional electricity companies, along with the sales of the electricity generating companies and the Scottish electricity companies, within the lifetime of the Parliament. The Department were responsible for the first two sales. The Scottish Office Industry Department were responsible for the sale of the Scottish companies. The Government decided that the regional electricity companies should be sold first. This was because, although none of the sales in this new sector was likely to prove straightforward, the market might be expected to regard the regional electricity companies as offering prospects of moderate growth at relatively low risk, compared with the electricity generating companies which were more exposed to competition.

2.3 The National Audit Office examined whether the Department had established a timetable for the sale which would leave room for the subsequent sales within the likely lifetime of the Parliament, and whether they had secured the sale of the Government's controlling interest in the regional electricity companies in accordance with that timetable.

2.4 In drawing up the timetable the Department faced a number of constraints. In particular, a General Election was seen as possible at any time from Spring 1991: consequently, any sale planned in the immediately preceding period, or from then onwards, might be called into question on that account. In addition, the

precise timing of the three sales, and of key stages in the preparations, had to avoid unsuitable periods for major public offers, such as August and Christmas. The Department also wished to avoid periods when the Government's financial plans were likely to be under review, because at such times there might be uncertainty about what could be written into the prospectus advertising the companies for sale.

2.5 The process of setting up the companies and establishing the new commercial and regulatory arrangements was completed on 31 March 1990. The Department needed most of the remainder of 1990 to complete their preparations for the sale. They decided to aim to sell the regional electricity companies by December 1990, on the basis that this would leave just enough time to sell the generating companies early in 1991, followed by the Scottish companies in the Spring of 1991. They aimed to keep open as long as possible the options of whether to sell all their shareholding or only a majority.

Outcome

2.6 The Department completed the sale of the regional companies, which were sold in their entirety, by their December 1990 target. They subsequently sold approximately 60 per cent of the shares in the generating companies in March 1991. The Scottish sale was completed in June 1991. The National Audit Office are currently studying these subsequent sales, on which I expect to report to Parliament in due course.

Maximising net proceeds

2.7 Within the overriding objective of completing the privatisation during the lifetime of the Parliament, the Department's first priority 1,vas to maximise the net proceeds of the sale, that is proceeds less costs.

2.8 The National Audit Office examined whether the Department had:

- identified the most appropriate method of sale, consistent with their other objectives:
- valued the businesses by reference to the most appropriate criteria;
- considered ways in which a proportion of any value not identified at the time of the sale might subsequently be recovered, for example through suitable clawback provisions;
- negotiated the sale on the best possible terms for the taxpayer.

Method of sale

2.9 Having regard, in particular, to their objective of widening and deepening share ownership among individuals, the Department decided that the most appropriate method of sale would be by floating the companies on the London Stock Exchange by public offer, offering the shares for sale to individual, institutional and overseas investors. The Department considered offering the shares for sale by public tender, in which the shares would be sold to the highest bidders. They concluded however that this method might have discouraged individual investors.

especially those considering applying for shares for the first time, thereby jeopardising their objective of widening ownership.

2.10 The Department therefore decided that the offer should be at a fixed price which would be the same for shares in each of the twelve companies. Individuals were allowed to apply for shares in individual companies. Institutional and overseas investors, however, had to apply for shares in package units, each unit consisting of 1,000 shares, made up of shares in each of the companies. The Department also decided. in the light of the strong advice of Kleinwort Benson and the brokers, and following precedents, that the offer should be underwritten, in order to ensure that the v sold the shares on offer and floated the companies in accordance with their timetable. The Department and their advisers also considered that, since this was a primary sale, and as there was no existing market price, underwriting would demonstrate to individual investors (and to the media who Influence their decisions) that the institutions believed the offer price to be reasonable.

2.11 Financial institutions underwriting an issue agree to buy, at a fixed price, any shares which remain unsold at the end of the period during which the shares are on offer (for a major privatisation usually about three weeks). This enables the seller to complete the sale. As a consequence, the price of the shares is effectively fixed by reference to the share price at which the financial institutions indicate, in

advance of the sale, that they are prepared to underwrite the offer.

2.12 Having decided to sell the shares by fixed price public offer, the Department considered how this method should be applied, in the circumstances of this sale, in order to maximise net proceeds. In line with previous flotations, the Department sought to create competing demand among the three types of investor concerned: individuals, institutions, and overseas, In particular, the Department built into the share offer structure a feature which had appeared in previous privatisations, whereby the proportion of shares provisionally reserved for allocation to individual investors as a group would be increased. In this case, the proportion would be raised from 34.4 per cent to as high as 54.6 per cent of the issue, depending on the level of subscription by individuals. The provisional allocations to institutional and overseas investors would be correspondingly reduced. This process is designed to add to the pressure on institutions to accept a higher price than they might otherwise offer, on the grounds that, if they do not, they risk losing part of their provisional allocation to individual investors responding to an attractively priced offer.

2.13 Against the background of a difficult and potentially volatile market, reflecting concerns about developments in the Gulf, the Department also considered, in the interests of maximising net proceeds, a range of possible technical innovations to this method of sale. These

included not fixing the price until the end of the offer period, in order to give protection to investors or the Department, depending on movements in market prices during that period. An alternative would have been to split the offer into two. The majority of shares would have been underwritten and placed with institutional and overseas investors, with dealing commencing the next day, thereby avoiding the uncertainty of the offer period. The remainder of the shares would have been offered to individual investors, over the usual period, but not underwritten.

2.14 The Department also considered whether institutional investors should be asked to specify in advance, via the Department's brokers, how many shares they would be prepared to buy at a range of prices specified by the Department, with subsequent allocations going to the highest indicative bids. This is known as book building. It contrasts with the method traditionally followed on the London market whereby brokers take confidential soundings among the institutions as to the price at which they would be prepared to buy the shares.

2.15 An alternative way of giving the Department a measure of protection against a rise in the market during the offer period would have been to provide that, in such an event, part of the shares provisionally allocated to institutional and overseas investors would be withdrawn. Such shares would be re-offered to these investors by way of tender towards the end of

the offer period. This technique, a version of which was adopted for, though not activated in, the British Petroleum sale, is known as a back-end tender. Another form of tender was used in the BAA sale, when a proportion of the shares were sold by tender open to all investors.

2.16 The Department thus studied a range of possible techniques and innovations. The implications of each option had to be analysed and appraised within the constraints of the timetable. Not all could in any case have been adopted simultaneously. In the event the Department accepted the strong recommendation of their advisers that such techniques were likely, in the circumstances of this sale, to entail more risk than benefit as regards maximising net proceeds. This was because the Department were seeking to sell substantial, new and untried companies in a sector which was itself new to the market: and at a time when market conditions were particularly unsettled because of the Gulf crisis and the deepening recession. Kleinwort Benson, the Department's lead advisers for the sale, advised that in the circumstances it would be imprudent to introduce such changes, because this might undermine confidence among the institutions. Nevertheless the Department sought to introduce a measure of competitive bookbuilding, by asking their brokers to provide, a week before the offer price was fixed, details of likely support at three prices.

Valuation of the businesses: dividend yield

2.17 ""hen a utility business is floated on the London Stock Exchange, the basis on which the offer price is normally fixed is the expected annual income return to shareholders, known as the yield. This was the basis adopted by the Department for this sale. The yield is usually expressed as a percentage, representing the proportion of the gross dividend to the share price. Thus to maximise proceeds it is necessary to seek as high dividends as possible consistent with company prospects. In this sale each £1 million of dividends was equivalent to some £16 million of proceeds.

2.18 Businesses commanding low yields are typically those which are seen by the market as offering good growth potential and/or low risk. These judgements also take account of how the market views the prospects of other companies, since they are in competition for investors' funds with the business being sold. The yield demanded by the market is also influenced by factors extraneous to the company, in particular interest rates and, more generally, prevailing levels of confidence in the market.

2.19 The lower the yield acceptable to investors, the greater the proceeds to the seller floating the company, because the price of the shares can be increased. Conversely, the higher the yield acceptable to investors, the lower the price has to be because, in both cases the yield has to be met from the same amount of total dividend.

Example

If the business expects to pay annual dividends totalling £1,000 and it is valued on a yield of ten per cent. the seller could offer say 10,000 shares at £1 each. This would result in sale proceeds of £10,000, If however the business was valued on a yield of five per cent. the price at which the 10,000 shares could be offered would be increased to £2. doubling sale proceeds to £20,000,

Valuation of the businesses: assets

2.20 As a separate exercise to pricing the offer. the Department needed to confirm the nature, quantity and value of the companies' assets. The prospectus set out the net asset values of the companies on both the historic cost basis (that is the original cost less depreciation) and the current cost basis (that is the replacement cost less depreciation), On the historic cost basis, this amounted to some £7.7 billion: on the current cost basis, some £16.1 billion.

2.21 In settling these valuations, the Department and their professional advisers reviewed the bases on which the companies' fixed assets were valued. Some 90 per cent were operational assets. For most of these, current costs were calculated by indexing historic costs. The Department and their advisers concluded that this was the best available valuation basis for

such assets, since they consist principally of specialised equipment (typically, pylons, wires. transformers and switch gear) which is essential to carrying on the electricity distribution business, and has no easily ascertainable value in other markets. The values of other operational assets, in particular land and buildings, were supported where appropriate by revaluation.

2.22 For the remaining ten per cent of fixed assets, in particular non-operational land and buildings, open market values for existing use were more readily ascertainable. In cooperation with the regional companies, the Department carried out a revaluation programme which focussed on those nonoperational assets most likely to be disposable, for example surplus property. Each of the regional companies appointed a firm of chartered surveyors and valuers to undertake the revaluation, on the basis of the survey costs being shared equally with the Department.

2.23 This revaluation programme produced a current cost value for the companies' non-operational land and building assets which was some £575 million more than the historic cost. This outcome was reflected in the prospectus.

Clawback

2.24 The Department considered the case for introducing claw back provisions to enable the taxpayer to benefit from value not identified at the time of the sale. The areas examined included land and buildings, where one of the

purposes of the Department's valuation review was to identify property with significant potential additional value.

Clawback on property gains

2.25 In view of the large number of properties concerned (over 100.000), the Department concluded that the best means of protecting the taxpayer's interest was to introduce clawback provisions applying to land and buildings generally, Under these arrangements. which cover non-operational land and buildings as well as interests in land within the distribution system, clawback will be triggered by any property gains, above certain thresholds, accruing or treated as accruing to the companies as a result of disposals, or deemed disposals, between 31 March 1990 and 31 March 2000, Any additional value realised above valuation as at 31 March 1990 or, in the case of non-operational properties, the historic cost, will be included in the gains subject to clawback, The Government will be paid half the gains from such disposals, after allowing for corporation tax. So far there have been no such receipts, No clawback will apply to disposals of specialised property to a purchaser who continues the existing operational use of the property until 31 March 2000.

Clawback on profits

2.26 The Department also considered introducing clawback on a wider basis, including a clawback on profits which might have extended over a

period of some years after the flotation. While the Department looked seriously at this approach, they decided against such an innovation on the grounds that it would detract from investors' normal interest in the sustainability of profits, and hence from proceeds, These views were strongly shared by the Department's advisers, principally on the grounds that such a clawback would have called into question the ability of the companies to maintain the expected dividends and dividend growth. The Department were advised that such a step would have been highly detrimental to the market's views of the companies and would have materially affected the yield at which they could be sold: and that the benefit of such a clawback would thus have been less than the loss of value through lower pricing. In addition, complex procedures and ground rules would have been needed to establish the basis for calculating "excess" profits for the purposes of the clawback, including allowance for investment and maintaining the businesses.

2.27 The Department's consideration did not specifically extend to whether there was a case for a more limited clawback on profits, for example to apply to at least some part of any profits above those forecast for the first year of trading (1990-91), Such a provision would have had regard to the fact that the companies were being sold on the basis of a very limited track record, and to the correspondingly cautious basis on which the profit forecasts for that year were drawn up. The Department told the

National Audit Office that, although the profit forecasts were prepared on a cautious and prudent basis, the level of dividends was the main determinant of proceeds, and that dividends were set having regard to sustainable profit levels rather than the levels forecast in the prospectus. In the Department's view and that of their advisers, this factor, along with the low levels of first year dividend cover that the directors of the regional electricity companies accepted as a result, effectively ensured that value was obtained from first year profits.

2.28 The dew of the Department is that in the circumstances of this sale, the introduction of profit clawback, even limited to the first Year. would have had a damaging impact on their negotiations with the directors about the levels of dividends and/or dividend covers which the directors might accept for that year, or on the yield, and that either of these effects would have had much more of a negative impact on proceeds than the potential profits to be clawed back.

2.29 Since the sale, all the companies have announced pre-tax profits, for 1990-91 higher than forecast in the sale prospectus. Figure 2 compares forecast with outturn for each company: it shows that the profits were overall 22 per cent {£212.4 million) higher than forecast in the prospectus. The three regional companies 'whom the National Audit Office consulted attribute these increases to the net outcome of developments that were different from the assumptions made at the time of the sale,

including a colder winter leading to higher demand, and, at the time, lower than expected electricity generation costs.

Figure 2: Regional Electricity Companies Pre-Tax Profits 1990-91

Electricity Company	Prospectus Forecast £million	Outturn £million	Variation	
			£million	%
Eastern	112.4	130.6	18.2	+16
East Midland's	88.9	119.1	30.2	+34
London	115.6	141.8	26.2	+23
Manweb	52.5	59.0	6.5	+12
Midlands	91.9	109.7	17.8	+19
Northern	73.1	89.2	16.1	+22
NORWEB	63.2	70.3	7.1	+11
SEEBOARD	60.5	81.4	20.9	+35
Southern	122.7	139.6	16.9	+14
South Wales	45.9	58.1	12.2	+27
South Western	44.9	66.2	21.3	+47
Yorkshire	115.6	134.6	19.0	+16
	987.2	1,199.6	212.4	+22

Source: Prospectus and Company Statements

This Figure Shows that trading profits of the twelve regional electricity companies for 1990-91 were overall 22 per cent (£214.2 million) more than forecast in the Prospectus.

2.30 These companies told the national Audit Office that their profit forecasts at the time of the sale had regard to the untested nature of the newly privatised industry, and the need for a high degree of assurance that they would produce at least the level of profits forecast in the prospectus. They said that their forecasting difficulties had been compounded by uncertainties over the effects of the recession on the demand for electricity, and the possible impact of the Gulf crisis on oil prices.

Negotiating the sale: debt injection

2.31 To maximise proceeds from the sale. The Department sought to have an appropriate part of their investment in the companies represented by debt at flotation. This required the injection of debt into the companies for which the companies received no cash. The debt attracts market rates of interest. Whether or not the introduction of new debt maximises total proceeds depends on a judgement as to which is the higher:

(a) the proceeds from repayment of the principal sum of the debt: or

(b) the additional equity proceeds that might be realised from the sale if that amount of debt was not introduced.

2.32 Proceeds tend to be maximised by the injection of a sustainable level of debt. Servicing debt capital out of any given level of profits is normally cheaper to a company than servicing equity capital. There are two reasons for this. First, interest on debt is tax deductible, while dividend payments are not. Second, dividends usually increase with time, which is not normally so in the case of interest, which if not fixed, will move only in accordance with general interest rates. At higher levels of injected debt. However, the proceeds of sale are likely to decline. This is because the costs of servicing debt beyond certain levels are likely to be perceived by investors a's unacceptably high in relation to earnings and a risk to the ability to pay dividends.

2.33 In floating the companies, the Department, therefore, had to have regard to the maximum amount of debt that the companies could bear without endangering their ability: to meet interest payments: to repay the debt when it became due: to pay dividends: and to provide for future investment.

2.34 The Department were advised and considered it reasonable that the amount of interest payable should on average be covered four times by the earnings of the companies, and that the ratio of borrowings to equity capital should be in the range of 35 to 50 per cent. The companies disputed this assessment, most of them arguing that the maximum should be 20 per cent. given the risks of the business, The Department,

however, persuaded them to accept ratios of between 31 and 43 per cent. Borrowings were agreed in total (including those for the National Grid Company) at £2.815 million. This meant that the Department had achieved through negotiation interest coyer for most of the twelve companies ranging from approximately three and a half times to four and a half times forecast earnings.

Negotiating the sale: dividend statements

2.35 Before agreeing a price with the underwriters the Department sought to promote the sale on the best possible terms for the taxpayer, in two ways. First, by creating demand for the shares through marketing. Second, as the shares were to be priced on yield, by securing from the companies satisfactory levels of first year dividends, In negotiations with the companies the Department achieved agreement to first year dividends totaling £326.5 million, very close to their earlier assessment of £330-340 million. They also had to negotiate statements about dividend policies and business prospects which were as positive as possible,

2.36 These statements had to be negotiated with the individual companies, whose directors were responsible for those elements of the prospectus. Failure subsequently to meet such commitments is seen by the market as a serious indictment of management. This placed the companies in a strong negotiating position. The Department, however, had the sanction of selling only a proportion of their shareholding, whereas the

management of the companies wanted the Department to dispose of it all.

2.37 A key stage in the sale process was the publication of the pathfinder prospectus on 2 November 1990. The pathfinder was used to stimulate institutional interest in the sale. It was a near final draft of the main prospectus, which was subsequently published on 21 November 1990 and set out the particulars of the companies to be offered for sale. The Department sought statements from the companies for the pathfinder prospectus that dividends would grow in real terms, having regard to the Department's real growth assumption of three to five per cent a year. This assumption underlay their negotiations with the companies over the price control regime and borrowings.

Negotiating the sale: sale of all the shareholding

2.38 The companies would only agree to statements about dividends and prospects which were acceptable to the Department on the understanding that the pathfinder prospectus also stated that the Government was "offering 100 per cent of the ordinary share capital of each of the regional electricity companies". On 25 October 1990 the Secretary of State agreed with the companies' condition, on the grounds that the Department's objective of obtaining acceptable dividend and prospects statements had been achieved.

2.39 The Department nevertheless kept open the option of a 60 per cent sale even after the pathfinder was published, should market conditions against the background of the Gulf crisis so dictate. The Department were however told by their lead advisers and lead brokers that. given the increasingly uncertain market conditions, and the companies' lack of a track record, such a retraction would be interpreted by the market as so defensive as to pose risks for the entire sale.

2.40 Another argument identified by the Department in favour of a 100 per cent sale was the risk that an Opposition statement about repurchase of sufficient shares to give more than 51 per cent state control of the companies could have reduced investor confidence in a partial sale. In addition there was the likelihood of considerable practical difficulties of subsequently selling a 40 per cent share in twelve different companies which by then would not be Government controlled. It would be far harder to co-ordinate such a sale than was the case while the companies were in Government ownership. The comparison of different companies' track records, which by then would be possible, would have been a further complication.

2.41 In the light of all these factors the Department concluded both that a 100 per cent sale was possible and that. in the circumstances of the sale, a partial sale would have signalled to the market an unduly tentative and uncertain approach.

Negotiating the sale: dividend cover

2.42 The brokers advised that in normal circumstances institutional investors would expect dividends to be covered not less than two and a half times by net profits, and that lower levels of dividend cover might adversely affect the yield. In this sale, each 0.1 per cent movement in the forecast yield at the final stage of pricing represented about £62 million of sale proceeds.

2.43 The dividend levels the Department negotiated with the companies for the first year (1990-91) would only be covered just under twice, on average, by the net profits forecast in the prospectus. Agreement on these dividend levels was possible principally because the companies accepted that dividends should be fixed not on the basis of the profits forecast for 1990-1991 but of sustainable profits. These reflected the recovery, in later years, of the profits from revenue allowed under the price control arrangements but not scored in the first year, and hence higher sustainable levels of dividend cover.

2.44 If these higher levels of dividend cover had not been perceived as sustainable. the stock would have been seen as riskier and the Department would have come under pressure to accept a higher yield. The brokers were, however. able to point out to the institutions that. as noted in the prospectus, the profit forecasts did not take into account the fact that inflation, by reference to which the companies' charges are controlled,

was likely to be higher than had been expected when the initial charges were set, although upward adjustment to charges on this account would be reflected in the profits for 1991-92 or later years. This enabled underlying dividend cover to be regarded as nearer two and a half times.

2.45 On the basis of these arguments, and of their other promotional efforts. by the end of the first week in November the Government's brokers had reduced the institutions' initial expectation of yield—from a range of 8.75 to 9 per cent—to 8.5 per cent. This represented increased proceeds of between £146 million and £284 million.

Negotiating the sale: pricing and underwriting the offer

2.46 The Department followed the traditional arrangements for underwriting. This takes place in two stages. First. a syndicate of primary underwriters, organised by the Department's lead underwriters, commit themselves to purchase the shares, if necessary, from the time the offer is announced until the sale has been completed. As soon as the offer is announced, however, sub-underwriting is offered to institutional investors, who then carry the risk until the sale is completed. If the issue cannot be sub-underwritten, the primary underwriters continue to carry the risk themselves. So the primary underwriters will not commit themselves unless the brokers can give them

confidence that the issue will be sub-underwritten.

2.47 Thus the most crucial part of the sale was pricing and underwriting the offer, which took place between Wednesday 14 November and Tuesday 20 November. During this period there was great stock market uncertainty. Three factors in particular contributed to this: the continuing Gulf crisis, the deepening recession, and the contest for the leadership of the Conservative Party which began on 14 November. In addition to these factors, there were long-standing and continuing doubts in some sectors of the press and the market as to whether the sale could actually be successfully undertaken. Accordingly, the primary underwriters of the offer looked for a high degree of confidence that the offer price would be robust during the offer period, in which market falls were seen y' the Department's advisers as a distinct, and perhaps likely, possibility. For their part, the Department were concerned that the first sale in the series of three should not be seen as a failure.

2.48 The Department's lead underwriters experienced difficulty in assembling a group of primary underwriters. on account of the uncertain market conditions. in particular because of the Gulf crisis. Following negotiations with the potential underwriters, the Department decided on 10 November that in the event of a stock market fall linked to the outbreak, or the imminent threat, of hostilities

in the Gulf, the sale could be halted, Even so, there continued to be difficulties in assembling the underwriting sale and the low rates of commission likely to be available.

Negotiating the sale: pricing decision

2.49 By the time the issue was priced on 18 November the question was whether it could be priced at 8.4 per cent. as recommended by a number of the Department's advisers, or at a lower level. The Department were keen to probe the latter. At the Department's preferred target of 8.25 per cent. this would have represented £94 million of additional proceeds. By this time the Department knew they had been successful in creating market tension: 7.3 million individuals had registered an interest in the offer. In addition, most of the Government's overseas advisers were generally confident of being able to underwrite their tranche of the issue at a yield of 8.25 per cent. provided the United Kingdom market would accept it.

2.50 Prior to the final pricing decision not all of the six United Kingdom brokers for the sale said they could complete their share of sub-underwriting at a yield of 8.25 per cent. One of the Government's brokers (not the lead broker) advised that, in the particularly difficult market circumstances at the time the offer had to be priced, they could not provide the primary underwriters with the required level of confidence at any lesser yield than 8.4 per cent. This was because a number of institutions had told them they would not sub-underwrite the

offer below that level, and this would have reduced the quality of the sub-underwriting list. The Department concluded that, although it might have been possible to arrange the sub-underwriting at that yield. it would not have been possible to give the primary underwriters the degree of confidence they wanted. This effectively presented the Department with a choice between proceeding with the offer at a yield of 8.4 per cent or withdrawing it altogether.

2.51 This choice also reflected concern expressed by the Department's brokers that none of the individual companies should be priced at a yield below 8 per cent. To achieve this with a weighted average yield of 8.25 per cent. the Department concluded that it would have been necessary to squeeze the range of yields for the twelve companies to an unrealistic degree. and that this would have made it more likely that one or more of the companies would have opened at a discount, which could have had a serious impact on the subsequent electricity sales.

2.52 The Secretary of State decided, on the advice of the Department and their advisers, that the offer should be priced at a yield of 8.4 per cent, giving a value for the shares issued in the companies of nearly £5.2 billion, at a share price of £2.40.

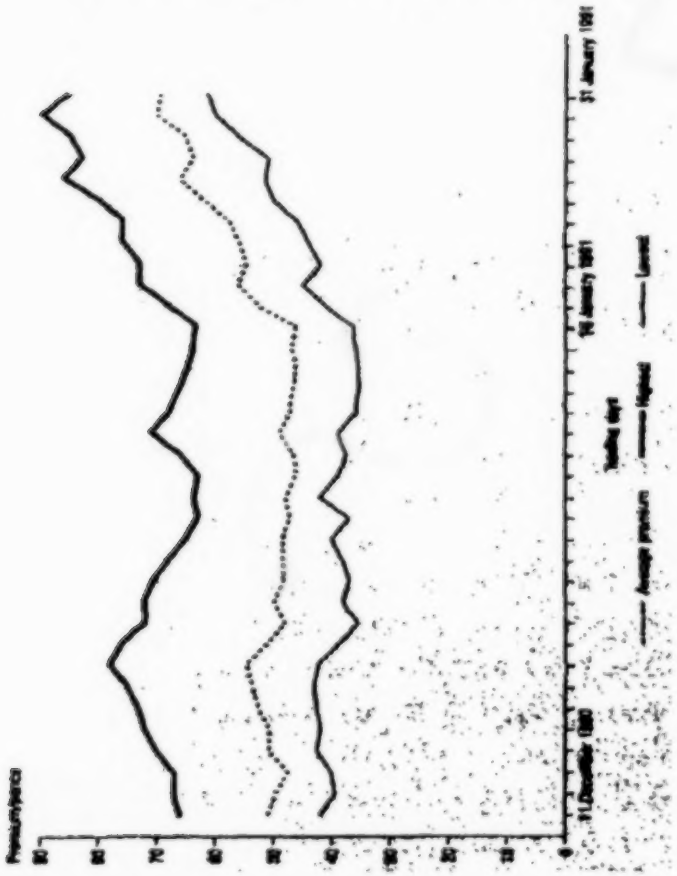
Outcome

2.53 At the close of the first day's dealing in the shares (11 December) the market valued the

companies at £6.3 billion, compared with their value of nearly £5.2 billion at the offer price, an increase of £1.1 billion. This is equivalent to a yield of about 6.7 per cent compared with the 8.4 per cent offered.

2.54 This increased value expressed itself in the premium at which the shares were traded. The level of premium in the aftermarket was significantly above the Department's target of 15 pence. The premium in fact averaged 49 pence for the first 24 days trading, to 16 January 1991, before rising to about 70 pence by the end of that month (Figure 3).

Figure 3: Share premium - Start of trading (11 December 1990) to 31 January 1991



Source: Published stock market prices at the close of trading

This figure shows that the average premium for all twelve electricity companies during the first 24 days of trading (to 16 January 1991) was 49 pence rising to just under 70 pence by 31 January the premium ranged from 35.5 pence to 90 pence

2.55 The Department asked their lean brokers to report on the performance of the companies' shares on the London Stock Exchange,

comparing the outcome with the lead broker's advice at the time of pricing, on behalf of the brokers' syndicate, that 8.4 per cent was the appropriate offer yield.

2.56 Between the setting of the price and the opening of dealings, the Financial Times All Share Index moved up by five per cent. British Gas stock by 10.6 per cent, and the Water Package by 13.7 per cent (17.9 per cent partly paid). See Figure 4.

Figure 4: Movements in share prices (fully paid basis) from the date issue was priced to 31 January 1991



Source: Published stock market prices at the close of trading

This figure compares movements In prices of the electricity package, the water package, British Gas. and shares generally In the weeks following the pricing of electricity offer.

20.57 The Department were advised by their brokers and other advisers that 30 pence of the unexpected element (34 pence) of the premium

of 49 pence could be explained by the general upward movements in the market which began the day after the issue was priced on 18 : November. They noted that most of the 19 pence balance of the 49 pence premium was comparable with the Department's target premium of 15 pence, leaving about four pence unexplained, but within a reasonable margin of pricing uncertainty.

2.58 The lead brokers advised that they would normally expect utilities to outperform the market in the final stages of a declining market. and to lead the market in the early stages of recovery, because they offered prospects of moderate growth and relatively low risk compared with companies more exposed to recession. In their view, this normal development might have been held back by the prospect of the sale of the regional electricity companies. This was because, until a clear perception of the likely success of that sale emerged, institutions were unable to make an accurate assessment of the call on their funds. There might therefore have been a tendency to hold back from making comparable investments, for example in water and gas.

2.59 The brokers advised however that these upward movements could not have been foreseen with any degree of confidence at the time of pricing the electricity flotation. Indeed, there were strong reasons (the Gulf crisis. the recession and the Conservative Party leadership contest) for feeling concern at the time of pricing that the

market as a whole might move downwards in the days immediately following.

2.60 The brokers added that, even if they had predicted the subsequent price movements, they would still not have been able to take them into account in the pricing, on the grounds that the market as a whole had not foreseen them (or else the price would have moved up sooner). Any attempt to take into account a future price rise which the market had not foreseen would have been seen as incorrect pricing, and would have led to a failed issue.

Widening and deepening share ownership

2.61 Encouraging wider and deeper share ownership among individual members of the public lay at the heart of a number of key decisions on the sale. These included the method chosen for the sale and the number of shares made available for allocation to individuals.

2.62 The Department had regard to the Treasury Minute responding to the 34th report of the Public Accounts Committee (1987-88) that it was not practicable to set quantified targets in relation to widening or deepening share ownership. While recognising the impracticality of setting precise quantified targets, the Public Accounts Committee had considered that it would be advantageous for departments to define in advance of sales the broad assumptions which underlie their objectives in relation to numbers of shareholdings held by individuals, employees, and institutions. They

should then systematically review how' these assumptions turned out in practice.

2.63 The National Audit Office examined whether the Department had:

- defined what they meant by widening and deepening share ownership:
- established appropriate targets or planning assumptions at relevant stages along the road to the sale:
- carried out appropriate research:
- monitored the outturn of the sale.

Definitions

2.64 The Department confirmed to the National Audit Office that by widening share ownership they meant persuading individuals who had not previously owned shares or. if they had, no longer did so, to purchase and retain shares. By deepening share ownership they meant persuading individuals who already owned shares to add to their portfolios by purchasing and retaining further shares.

Targets / planning assumptions: registrations

2.65 The Department adopted specific targets for the marketing campaign, which related to the encouragement of registrations and which were based on the levels occurring in previous sales, particularly of gas. Having regard to these targets and levels, the Department adopted a broad planning assumption that up to between

six and nine million people might register their interest in the sale. This range also set some benchmarks for planning the logistics and for budgeting. The Department's broad aim was achieved: some 7.3 million individuals registered.

Targets / planning assumptions: subscriptions

2.66 The Department's minimum requirement was to have the public offer fully subscribed. In order however to trigger reallocation from institutional and overseas investors to individual investors, they required subscription of at least 2,25 times the original level of the public offer. They also wished the sale to be compared favourably with other successful public offers. Having regard to these factors, as well as to allow a margin for uncertainty, they applied a broad planning assumption that the public offer needed to be some three to four times subscribed, This assumption underlay the Department's monitoring of, in particular, their marketing campaign.

2.67 The regular appraisals which the Department received from their advisers indicated, prior to the offer, that the level of subscription for the public offer was likely to be broadly in line with the Department's planning assumption of three to four times subscription. Later, during the actual offer period, it emerged that a much higher level of subscription might be likely. In the event, these shares were 10.7 times subscribed.

Targets / planning assumptions: applications

2.68 The Department also made broad planning assumptions for logistical and budget planning purposes about the number of share applications they were likely to receive from individuals. These assumptions drew on the levels of interest and indicative investment levels shown by market research and registrations, as well as levels occurring in previous sales. They were progressively refined during the period leading to the close of the offer. in the light of a programme of surveys to monitor the impact of the marketing campaign, and of levels of demand among registrants and the general public. By the close of the offer, the Department's planning assumption about the number of applications to be processed had risen from some six million to perhaps ten million, the upper end of their contingency range.

2.69 In the event, the number of applications was 12,75 million-two and a half times the number of applications made in connection with any previous rivatization, The Department and their adivsers attribute this outcome to strong media endorsement late in the offer period, when the market was rising; in particular media recommendations that applications should be made for small numbers of shares in several or all of the twelve companies.

2.70 The Department did not adopt formal target ranges for the total number of applications, or for the proportion relating to new shareholders.

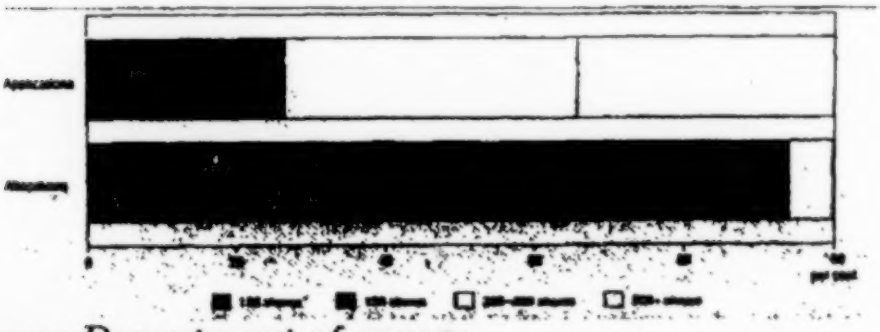
This was because they considered such targets artificial. Had they become known, and then not met or exceeded. this could have impacted adversely on perceptions of success, and hence risked unnecessarily constraining the Department's room for manoeuvre on pricing. They and their advisers also concluded that the outcome would be largely determined by market conditions and media endorsement which were too uncertain to predict with any degree of confidence.

Share allocations

2.71 The tranche of shares previously reserved for allocation to individual investors was accordingly increased from 34.4 per cent to 54.6 per cent of the total offer. After this adjustment the number of shares applied for was 6.4 times the number available. The allocation policy was therefore severely constrained by the overall number of shares available, as well as by London Stock Exchange limits on the extent of preferential allocation to registered customers, in the context of a public offer.

2.72 Applications for more than the minimum admissible number of 100 shares were scaled down. Figure 5 shows that, while just over 25 per cent of applications were for 100 shares, some 88 per cent of allocations were of no more than that number. The allocation policy adopted by the Secretary of State resulted in the creation of some nine million shareholdings out of 12.75 million applications.

Figure 5: Allocation of shares to individual investors (excluding employees)



Source Department of energy

Note: In one case SEEBOARD, 90 shares were allocated

This figure compares applications for shares by individual investors with actual allocations were of no more than that number.

Outturn: monitoring

2.73 Specific research, conducted by the Department in early January 1991, between the sale of the regional electricity companies and that of the generating companies. indicated that around 1.5 to 1.8 million people (just under a third of the estimated five to six million people buying shares in the regional electricity companies) did not previously have any share holdings. This level of new shareholders has been broadly borne out by research conducted in connection with subsequent sales. A separate, general, survey commissioned by the Office of Population Censuses and Surveys on behalf of the Treasury and the London Stock Exchange, was also carried out in January and February 1991. Although not conducted on precisely the same

basis as the Department's research, its findings were broadly consistent as to the proportions of new share ownership it implied. It indicated that about a quarter of all investors in the regional electricity companies held only electricity shares and so were first time buyers or had sold any previous holdings.

2.74 The Department had carried out a survey of the previous water sale to ascertain the key factors that had influenced individuals' investment decisions. They also surveyed, in preparation for the subsequent sale of the generating companies, what had influenced those who had chosen not to buy the regional electricity companies shares. The Department did not however, carry out any further research after the sale to examine why people had applied for shares, and why certain people sold their shares while others retained them. The purpose of such research would have been to provide more information on key factors influencing investors' decisions, for example the impact of advertising, incentives, media comment and the expected and actual level of the aftermarket premium.

2.75 The Department believed that such additional research was not strictly necessary to their purposes, since investors' "intentions' for the sale in prospect were seen as more relevant than their behaviour in past sales: and since a considerable amount of research had been carried out before the sale into these factors, including people's awareness and their likelihood of applying for shares. They have also

noted: that advertising is directed at, and its impact largely evidenced by the number of registrations; that retention levels are higher where incentives are present: and that the final level of applications is influenced by media comment. As to why some shareholders disposed of their shares, previous research and evidence from earlier sales had indicated that the higher the level of premium in the aftermarket the more likely the investor is to sell. Against this background, and given the need to keep down costs, the Department and its advisers did not think it would be cost-effective to undertake further research in this area.

2.76 Figure 6 shows that some 40 per cent of the original nine million share holdings were sold by 31 January 1991, and that, overall 60 per cent had been sold by 30 June 1991. For share holdings with an incentive entitlement attached, however, the rate of selling was no more than 20 per cent by the end of January and 30 per cent by the end of June.

Figure 6: Reduction of shareholdings to 30 June 1991

[Figure 6 was omitted in printing this appendix]

This figure shoes that some 40 per cent of the original shareholdings were sold by 31 January 1991, and that overall 60 per cent had been sold by 30 June 1991. For shareholdings with an incentive attached, however, the rate of selling was no more than 20 per sent by 31 January 1991 and 30 per cent by 30 June 1991.

Achieving overall recognition that the sale had been a success

2.77 The Department aimed to achieve the overall recognition that the sale of the regional electricity companies had been a success. and thus to lay a solid foundation for subsequent electricity utility sales.

2.78 The Department told the National Audit Office that this objective was directed towards creating favourable perceptions of the sale on the part of the media and institutional and individual investors, and hence favourable conditions for the subsequent electricity offers.

2.79 Some aspects of the sale received adverse comment. There was some disappointment. for example, over the levels of share allocations made in response to the higher than expected numbers of applications and of subscription. The Department's view is that these factors did not produce such an adverse effect as to detract from perceptions of the overall success of the sale.

2.80 The Department consider that the strong media endorsement of the sale, together with the unprecedentedly large number of applications and sufficient over-subscription levels to trigger the reallocation of shares from overseas and institutions to individuals, created a strong perception of success which fully met the concerns earlier expressed by commentators about the flotability of the new and complex electricity industry. The strength of public

demand required some difficult decisions to be made on share allocation. But the Department consider that the achievement of the subsequent electricity sales with many of the structural innovations considered but not thought prudent for. or beneficial to, this sale, also reflects positively on the foundations laid.

Achieving a modest premium

2.81 In pursuit of their other sale objectives, the Department aimed to generate the expectation among potential investors that the shares would trade at a modest premium following the start of dealings on the London Stock Exchange. and to achieve such a premium.

Target

2.82 Initially, the Department set a target for the premium of ten per cent of the fully paid price, equivalent to 24 pence. On 18 November the Department reduced this target to six per cent, equivalent to 15 pence. This was in order to maximise net proceeds, while still offering encouragement to investors.

Outturn

2.83 In the event. at 49 pence the level of premium in the aftermarket was significantly above the Department's target. Thirty pence of the premium was attributable to the general upward movements in the market which began after the offer was priced. Most of the 19 pence balance was equivalent to the Department's target premium of 15 pence. leaving about four

pence unexplained. This was within a reasonable margin of pricing uncertainty (see paragraph 2.57) for this sale. In the view of the National Audit Office and Hambros, it suggests however that the Department's target was perhaps ambitious in the circumstances of this sale.

* * *

EXHIBIT 36-P

LABOUR PARTY'S 1997 ELECTION MANIFESTO

I believe in Britain. It is a great country with a great history. The British people are a great people. But I believe Britain can and must be better: better schools, better hospitals, better ways of tackling crime, of building a modern welfare state, of equipping ourselves for a new world economy.

I want a Britain that is one nation, with shared values and purpose, where merit comes before privilege, run for the many not the few, strong and sure of itself at home and abroad.

I want a Britain that does not shuffle into the new millennium afraid the future, but strides into it with confidence.

I want to renew our country's faith in its ability of its government and politics to deliver this new Britain. I want to do it by making a limited set of important promises and achieving them. This is the purpose of the bond of trust I set out at the end of this introduction, in which ten specific commitments are put before you. Hold us to them. They are our covenant with you.

I want to renew faith in politics by being honest about the last 18 years. Some things the Conservatives got right. We will not change them. It is where they got things wrong that we will make change. We have no intention or desire to replace one set of dogmas by another.

I want to renew faith in politics through a government that will govern in the interest of the many, the broad majority of people who work hard, play by the rules, pay their dues and feel let down by a political system that gives the breaks to the few, to an elite at the top increasingly out of touch with the rest of us.

And I want, above all, to govern in a way that brings our country together, that unites our nation in facing the tough and dangerous challenges of the new economy and changed society in which we must live. I want a Britain which we all feel part of, in whose future we all have a stake, in which what I want for my own children I want for yours.

A new politics

The reason for having created new Labour is to meet the challenges of a different world. The millennium symbolises a new era opening up for Britain. I am confident about our future prosperity, even optimistic, if we have the courage to change and use it to build a better Britain.

To accomplish this means more than just a change of government. Our aim is no less than to set British political life on a new course for the future.

People *are* cynical about politics and distrustful of political promises. That is hardly surprising. There have been few more gross breaches of faith than when the Conservatives under Mr. Major promised, before the election of 1992, that they would not raise taxes , but would cut them *every* year; and then went on to raise them by the largest amount in peacetime history starting in the first Budget after the election.

The Exchange Rate Mechanism as the cornerstone of economic policy, Europe, health, crime, schools, sleaze—the broken promises are strewn across the country's memory.

The Conservatives' broken promises taint all politics. That is why we have made it our guiding rule not to promise what we cannot deliver; and to deliver what we promise. What follows is not the politics of a 100 days that dazzles for a time, then fizzles out. It is not the politics of a revolution, but of a fresh start, the patient rebuilding and renewing of this country—renewal that can take root and build over time.

That is one way in which politics In Britain will gain a new lease of life. But there is another. We aim to put behind us the bitter political struggles of left and right that have torn our country apart for too many decades. Many of these conflicts have no relevance whatsoever to the modern world—public versus private, bosses versus workers middle class versus working class. It is time for this country to move on and move forward. We are proud of our history proud of what we have achieved—but we must learn from our history, not be chained to it.

New Labour

The purpose of new Labour is to give Britain a different political choice: the choice between a failed Conservative government, exhausted and divided in everything other than its desire to cling on to power, and a new and revitalised Labour Party that has been resolute in transforming itself into a party of the future. We have rewritten our constitution the

new Clause IV, to put a commitment to enterprise alongside the commitment to justice. We have changed the way we make policy, and put our relations with the trade unions on a modern footing where they accept they can get fairness but no favours from a Labour government. Our MPs are all now selected by ordinary party members, not small committees or pressure groups. The membership itself has doubled to over 400.000, with half the members having joined since the last election.

We submitted our draft manifesto *new Labour new life for Britain* to a ballot of all our members, 95 per cent of whom gave it their express endorsement.

We are a national party, supported today by people from all walks of life from the successful businessman or woman to the pensioner on a council estate. Young people have flooded in to join us in what is the fastest growing youth section of any political party in the Western world.

The vision

We are a broad-based movement for progress and justice. New Labour is the political arm of none other than the British people as a whole. Our values are the same: the equal worth of all with no one cast aside: fairness and justice within strong communities.

But we have liberated these value from outdated dogma or doctrine, and we have applies these values to the modern world.

I want a country in which people get on, do well, make a success of their lives. I have no time for the

politics of envy. We need more successful entrepreneurs, not fewer of them But these life-chances should be for all the people. And I want a society in which ambition and compassion are seen as partners not opposites—where we value public service as well as material wealth.

New Labour believes in a society where we do not simply pursue our own individual aims but where we hold main aims in common and work together to achieve them. How we build the industry and employment opportunities of the future; how we tackle the division and inequality in our society; how we care for and enhance our environment and quality of life; how we develop modern education and health services; how we create communities that are safe, where mutual respect and tolerance are the order of the day. These are things we must achieve together as a country.

The vision is one of national renewal, a country with drive, purpose and energy. A Britain equipped to prosper in a global economy of technological change; with a modern welfare state; its politics more accountable; and confident of its place in the world.

Programme: a new centre and centre-left politics

In each area of policy a new and distinctive approach has been mapped out, one that differs both from the solutions of the old left and those of the Conservative right. This is why new Labour is new. We believe in the strength of our values, but we recognise also that the policies of 1997 cannot be those of 1947 or 1967. More detailed policy has been

produced by us than by any opposition in history. Our direction and destination are clear.

The old left would have sought state control of industry. The Conservative right is content to leave all to the market. We reject both approaches. Government and industry must work together to achieve key objectives aimed at enhancing the dynamism of the market, not undermining it.

In **industrial relations** we make it clear that there will be no return to flying pickets, secondary action, strikes with no ballots or the trade union law of the 1970s. There will instead be basic minimum rights for the individual at the workplace, where our aim is partnership not conflict between employers and employees.

In **economic management**, we accept the global economy as a reality and reject the isolationism and 'go-it-alone' policies of the extremes of right or left.

In **education**, we reject both the idea of a return to the 11-plus and monolithic comprehensive schools that take no account of children's differing abilities. Instead we favour all-in schooling which identifies the distinct abilities of individual pupils and organises them in classes to maximise their progress in individual subjects. In this way we modernise the comprehensive principle, learning from the experience of its 30 years of application.

In **health** policy, we will safeguard the basic principles of the NHS, which we founded, but will not return to the top-down management of the 1970s. So we will keep the planning and provision of healthcare

separate, but put planning on a longer-term, decentralised and more co-operative basis. The key is to root out unnecessary administrative cost, and to spend money on the right things—frontline care.

On **crime**, we believe in personal responsibility and in punishing crime, but also tackling its underlying causes—so, tough on crime, tough on the causes of crime, different from the Labour approach of the past and the Tory policy of today.

Over-centralisation of **government** and lack of accountability was a problem in governments of both left and right. Labour is committed to the democratic renewal of our country through decentralisation and the elimination of excessive government secrecy.

In addition, we will face up to the new issues that confront us. We will be the party of **welfare reform**. In consultation and partnership with the people, we will design a modern welfare state based on rights and duties going together, fit for the modern world.

We will stand up for Britain's interests in **Europe** after the shambles of the last six years, but, more than that, we will lead a campaign for reform in Europe. Europe isn't working in the way this country and Europe need. But to lead means to be involved, to be constructive, to be capable of getting our own way.

We will put concern for the **environment** at the heart of policymaking, so that it is not an add-on extra, but informs the whole of government, from housing and energy policy through to global warming and international agreements.

We will search out at every turn new ways and new ideas to tackle the new issues: how to encourage more flexible working hours and practices to suit employees and employers alike; how to harness the huge potential of the new information technology; how to simplify the processes of the government machine; how to put public and private sector together in partnership to give us the infrastructure and transport system we need.

We will be a radical government. But the definition of radicalism will not be that of doctrine, whether of left or right, but of achievement. New Labour is a party of ideas and ideals but not of outdated ideology. What counts is what works. The objectives are radical. The means will be modern.

So the party is transformed. The vision is clear. And from that vision stems a modern programme of change and renewal for Britain. We understand that after 18 years of one-party rule, people want change, believe that it is necessary for the country and for democracy, but require faith to make the change.

We therefore set out in the manifesto that follows ten commitments, commitments that form our bond of trust with the people. They are specific. They are real. Judge us on them. Have trust in us and we will repay that trust.

Our mission in politics is to rebuild this bond of trust between government and the people. That is the only way democracy can flourish. I pledge to Britain a government which shares their hopes, which understands their fears, and which will work

as partners with and for all our people, not just the privileged few. This is our contract with the people.

Over five years of a Labour government:

1 Education will be our number one priority, and we will increase the share of national income spent on education as we decrease it on the bills of economic and social failure

2 There will be no increase in the basic or top rates of Income tax

3 We will provide stable economic growth with low inflation, and promote dynamic and competitive business and industry at home and abroad

4 We will get 250,000 young unemployed off benefit and into work

5 We will rebuild the NHS, reducing spending on administration and increasing spending on patient care

6 We will be tough on crime and tough on the causes of crime, and halve the time it takes persistent juvenile offenders to come to court

7 We will help build strong families and strong communities, and lay the foundations of a modern welfare state in pensions and community care

8 We will safeguard our environment, and develop an integrated transport policy to fight congestion and pollution

9 We will clean up politics, decentralise political power throughout the United

Kingdom and put the funding of political parties on a proper and accountable basis

10 We will give Britain the leadership in Europe which Britain and Europe need

We have modernised the Labour Party and we will modernise Britain. This means knowing where we want to go; being clear-headed about the country's future; telling the truth: making tough choices; insisting that all parts of the public sector live within their means; taking on vested interests that hold people back; standing up to unreasonable demands from any quarter; and being prepared to give a moral lead where government has responsibilities It should not avoid.

Britain does deserve better. And new Labour will be better for Britain.

/s/ Tony Blair

* * *

The Conservatives have in 18 years created two long, deep recessions.

We have experienced the slowest average growth rate of any similar period since the Second World War. There has been a fundamental failure to tackle the underlying causes of inflation, of low growth and of unemployment. These are:

- too much economic instability, with wild swings from boom to bust
- too little investment in education and skills, and in the application of new technologies
- too few opportunities to find jobs

- start new businesses or become self-employed
- too narrow an industrial base
- and too little sense of common purpose in the workplace or across the nation.

Britain can do better. We must build on the British qualities of inventiveness, creativity and adaptability. New Labour's objective is to improve living standards for the many, not just the few. Business can and must succeed in raising productivity. This requires a combination of a skilled and educated workforce with investment in the latest technological Innovations, as the route to higher wages and employment.

An explicit objective of a Labour government will be to raise the trend rate of growth by strengthening our wealth-creating base. We will nurture investment in industry, skills, infrastructure and new technologies. And we will attack long-term unemployment, especially among young people. Our goal will be educational and employment opportunities for all.

Economic stability is the essential platform for sustained growth. In a global economy the route to growth is stability not inflation. The priority must be stable, low-inflation conditions for long-term growth. The root causes of inflation and low growth are the same—an economic and industrial base that remains weak. Government cannot solve all economic problems or end the economic cycle. But by spending wisely and taxing fairly, government can help tackle the problems. Our goals are low inflation, rising

living standards and high and stable levels of employment.

Spending and tax: new Labour's approach

The myth that the solution to every problem is increased spending has been comprehensively dispelled under the Conservatives. Spending has risen. But more spending has brought neither greater fairness nor less poverty. Quite the reverse—our society is more divided than it has been for generations. The level of public spending is no longer the best measure of the effectiveness of government action in the public interest. It is what money is actually spent on that counts more than how much money is spent.

The national debt has doubled under John Major. The public finances remain weak. A new Labour government will give immediate high priority to seeing how public money can be better used.

New Labour will be wise spenders, not big spenders. We will work in partnership with the private sector to achieve our goals. We will ask about public spending the first question that a manager In any company would ask—can existing resources be used more effectively to meet our priorities? And because efficiency and value for money are central, ministers will be required to save before they spend.

Save to invest is our approach, not tax and spend.

The increase in taxes under the Conservatives is the most dramatic evidence of economic failure. Since 1992 the typical family has paid more than £2.000 in

extra taxes—the biggest tax hike in peacetime history, breaking every promise made by John Major at the last election. The tragedy is that those hardest hit are least able to pay. That is why we strongly opposed the imposition of VAT on fuel: it was Labour that stopped the government from increasing VAT on fuel to 17.5 per cent.

Taxation is not neutral in the way it raises revenue. How and what governments tax sends clear signals about the economic activities they believe should be encouraged or discouraged, and the values they wish to entrench in society. Just as, for example, work should be encouraged through the tax system, environmental pollution should be discouraged.

New Labour will establish a new trust on tax with the British people. The promises we make we will keep. The principles that will underpin our tax policy are clear:

- to encourage employment opportunities and work incentives for all
- to promote savings and investment
- and to be fair and be seen to be fair.

New Labour is not about high taxes on ordinary families. It is about social justice and a fair deal.

New Labour therefore makes the following economic pledges.

Fair Taxes

There will be no return to the penal tax rates that existed under both Labour and Conservative governments in the 1970s.

To encourage work and reward effort, we are pledged not to raise the basic or top rates of income tax throughout the next Parliament.

Our long-term objective is a lower starting rate of income tax of ten pence in the pound. Reducing the high marginal rates at the bottom end of the earning scale—often 70 or 80 per cent—is not only fair but desirable to encourage employment.

This goal will benefit the many, not the few. It is in sharp contrast to the Tory goal of abolishing capital gains and inheritance tax, at least half the benefit of which will go to the richest 5,000 families in the country.

We will cut VAT on fuel to five per cent, the lowest level allowed. We renew our pledge to end IT to food, children's clothes, books and newspapers and public transport fares.

We will also examine the interaction of the tax and benefits systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life.

No risks with inflation

We will match the current target for low and stable inflation of 2.5 per cent or less. We will reform the Bank of England to ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political manipulation.

Strict rules for government borrowing

We will enforce the 'golden rule' of public spending—over the economic cycle, we will only borrow to invest and not to fund current expenditure.

We will ensure that—over the economic cycle—public debt as a proportion of national income is at a stable and prudent level.

Stick to planned public spending allocations for the first two years of office

Our decisions have not been taken lightly. They are a recognition of Conservative mismanagement of the public finances. For the next two years Labour will work within the departmental ceilings for spending already announced. We will resist unreasonable demands on the public purse, including any unreasonable public sector pay demands.

Switch spending from economic failure to investment

We will conduct a central spending review and departmental reviews to assess how to use resources better, while rooting out waste and inefficiency in public spending.

Labour priorities in public spending are different from Tory priorities.

Tax reform to promote saving and Investment

We will introduce a new individual savings account and extend the principle of TESSAs and PEPs to promote long-term saving. We will review the corporate and capital gains tax regimes to see how

the tax system can promote greater long-term investment.

Labour's welfare-to-work Budget

We will introduce a Budget within two months after the election to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities, introduced in this Budget after we have consulted the regulators.

* * *

There are over one million fewer jobs in Britain than in 1990. One in five families has no one working. One million single mothers are trapped on benefits. There is a wider gap between rich and poor than for generations.

We are determined not to continue down the road of a permanent have-not class, unemployed and disaffected from society. Our long-term objective is high and stable levels of employment. This is the true meaning of a stakeholder economy—where everyone has a stake in society and owes responsibilities to it.

The best way to tackle poverty is to help people into jobs—real jobs. The unemployed have a responsibility to take up the opportunity of training forces or work, but these must be real opportunities. The government's workfare proposals - with a success rate on one in ten—fail this test.

Labour's welfare-to-work programme will attack unemployment and break the spiral of escalating

spending on social security. A one-off windfall levy on the excess profits of the privatised utilities will fund our ambitious programme.

Every young person unemployed for more than six months in a job or training

We will give 250,000 under-25s opportunities for work, education and training. Four options will be on offer, each involving day-release education or training leading to a qualification:

- private-sector job: employers will be offered a £60-a-week rebate for six months
- work with a non-profit voluntary sector employer, paying a weekly wage, equivalent to benefit plus a fixed sum for six months
- full-time study for young people without qualifications on an approved course
- a job with the environment taskforce , I in ked to Labour' s citizens' service programme.

Rights and responsibilities must go hand in hand, without a fifth option of life on full benefit.

Every 16 and 17 year-old on the road to a proper qualification by the year 2000

Nearly a third of young people do not achieve an NVQ level two qualification by age 19. All young people will be offered part-time or full-time education after the age of 16. Any under-18 year-old in a job will have the right to study on an approved course for qualifications at college. We will replace the failed Youth Training scheme with our new Target 2000

programme, offering young people high-quality education and training.

Action on long-term unemployment

New partnerships between government and business, fully involving local authorities and the voluntary sector, will attack long-term joblessness. We will encourage employers to take on those who have suffered unemployment for more than two years with a £75-a-week tax rebate paid for six months, financed by the windfall levy. Our programme for the phased release of past receipts from council house sales will provide new jobs in the construction industry.

Lone parents into work

Today the main connection between unemployed lone parents and the state is their benefits. Most lone parents want to work, but are given no help to find it. New Labour has a positive policy. Once the youngest child is in the second term of full-time school, lone parents will be offered advice by a proactive Employment Service to develop a package of job search, training and after-school care to help them off benefit.

Customised, personalized services

We favour initiatives with new combinations of available benefits to suit individual circumstances. In new and innovative 'Employment Zones' personal job accounts will combine money currently available for benefits and training, to offer the unemployed new options—leading to work and independence. We will co-ordinate benefits, employment and career services,

and utilise new technology to improve **their** quality and efficiency.

Fraud

Just as we owe it to the taxpayer to crack down on tax avoidance, so we must crack down on dishonesty in the benefit system. We will start with a clampdown on Housing Benefit fraud, estimated to cost £2 billion a year, and will maintain action against benefit fraud of all kinds.

* * *

EXHIBIT 43-P

THE CHANCELLOR'S 1997 BUDGET SPEECH

JULY 2, 1997

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1. The Budget that I lay before the House today represents more than an allocation of resources and an accounting of revenues.

2. Because behind the numbers and statistics the central purpose of this Budget is to ensure that Britain is equipped to rise to the challenge of the new and fast changing global economy. Not just a few of us. But everyone.

3. The impact of the global market in goods and services, and of rapidly advancing technology, is now being felt in every home and every community in our country.

4. New products, new services, new opportunities challenge us to change; old skills, old jobs, old industries have gone and will never return.

5. Yet for our country, the first industrial nation, this new global economy driven by skills, creativity, and adaptability offers a historic opportunity.

6. The dynamic economies of the future will be those that unlock the talent of all their people, and our creativity, our adaptability, our belief in hard work and self-improvement, the very qualities that made Britain lead the world in the 18th and 19th centuries are precisely the

qualities we need to make Britain a strong economic power in the 21st century.

7. But to achieve this we must address the four weaknesses that have held us back for too long and for too many years—instability, underinvestment, unemployment, and the waste of talent.

8. In this Budget I will address each of these weaknesses in turn to ensure stability, investment, work, and opportunity for all.

* * *

Welfare and work

95. In the new economy however, where capital, inventions, even raw materials are mobile, Britain has only one truly national resource: the talent and potential of its people.

96. Yet in Britain today one in five of working age households has no one earning a wage.

97. In place of welfare there should be work.

98. So today this Budget is taking the first steps to create the new welfare state for the twenty first century.

99. The welfare state was and remains a great British achievement. It was set up to provide security for all, and opportunity for all, goals as relevant today as in 1945.

100. But for millions out of work or suffering poverty in work, the welfare state today denies rather than provides opportunity.

101. It is time for the welfare state to put opportunity again in peoples' hands.

102. First, everyone in need of work should have the opportunity to work.

103. Second, we must ensure work pays.

104. Third, everyone who seeks to advance through employment and education must be given the means to advance.

105. So we will create a new ladder of opportunity that will allow the many, by their own efforts, to benefit from opportunities once open only to a few.

106. Starting from next year, every young person aged 18-25 who is unemployed for more than six months will be offered a first step on the employment ladder.

107. Tomorrow the Secretary for Education and Employment will detail the four options, all involve training leading to qualifications:

- a job with an employer;
- work with a voluntary organisation;
- work on the environmental task force;
- and, for those without basic qualifications, full time education or training,

108. With these new opportunities for young people come new responsibilities. There will be no fifth option—to stay at home on full benefit. So when they sign on for benefit they will be signing up

for work. Benefits will be cut if young people refuse to take up the opportunities.

109. This new deal for the young—is comprehensive, rich in opportunity, linked to the development of skills and has already attracted the support of some of Britain's leading companies.

110. I urge every business to play its part in this national crusade to equip this country for the future by taking on young unemployed men and women.

111. I appeal to every voluntary organisation to make a further contribution to their community by taking on a young person.

112. And I will make it possible for every member of this House to act as an ambassador for this venture, encouraging young people in their constituencies, consulting, talking to local businesses and bringing them together to play their part in this new deal for young people.

113. There are 350,000 adult men and women who have been out of work for two years or longer. The second component of our Welfare to Work programme will offer employers a £75 a week subsidy to employ long-term unemployed men and women. Yet many of them who lack skills are debarred by the 16 hour rule from obtaining them. For this group—the unskilled—the 16 hour rule will be relaxed. So that when the long-term unemployed sign on for benefit they will now sign up for work or training.

114. This programme of £3.5 billion—which includes an unallocated reserve of £500 million—will be the main item funded from the windfall tax on the excess profits of the privatised utilities, the details of which I will give the House shortly.

* * *

Windfall Tax

188. Our reform of the welfare state—and the programme to move the unemployed from welfare to work—is funded by a new and one off windfall tax on the excess profits of the privatised utilities.

189. The tax will apply to companies privatised by flotation, and subject to economic regulation under specified acts of Parliament.

190. In determining the details of the tax, I believe I have struck a fair balance between recognising the position of the utilities today and their under-valuation and under regulation at the time of privatisation.

191. The windfall tax will be related to the excessively high profits made under the initial regime.

192. A company's tax bill will be based on the difference between the value that was placed on it at privatisation, and a more realistic market valuation based on its after-tax profits for up to the first 4 full accounting years following privatisation.

193. In preparing the windfall tax we looked more broadly at the position of the affected

companies. As a result of my earlier announcement—justified on its own merits—to reduce the gas levy to zero, I am satisfied that no company faces an unduly heavy tax burden.

194. The windfall tax will raise some £2.1 billion from the electricity sector, around £1.65 billion from the water sector, and some £1.45 billion from the remaining companies. After taking the reduction in the gas levy into account, which will cost the Government £400 million over the next three years, the net effect of the gas levy and the windfall tax together will raise £4.8 billion.

195. After consulting the regulators, it is my judgement that the tax can be paid without any impact on prices, investment, or the quality of service to customers; or, in my view, on employment.

196. In recent weeks many companies have asked to pay the tax in instalments. I have now agreed that this shall be the case. It will be a one-off tax payable in 2 instalments. The first instalment will be paid on 1 December 1997, the second a year later.

197. Full details of how the tax will apply—and the companies who will pay it—will be set out in an Inland Revenue press release available at the conclusion of this statement.

* * *

EXHIBIT 44-J

U.K. INLAND REVENUE ANNOUNCEMENT

INLAND REVENUE 1

JULY 2, 1997

WINDFALL TAX

The Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities. The one-off tax will apply to companies privatised by flotation and regulated by statute. The tax will be charged at a rate of 23 per cent on the difference between company value, calculated by reference to profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation. The expected yield is around 5.2 billion Pounds.

DETAILS

Companies affected

1. The tax will apply to companies privatised by flotation and regulated (or with a subsidiary regulated) by relevant privatising statutes. These are the Telecommunications Act 1984, the Airports Act 1986, the Gas Act 1986, the Water Act 1989, the Electricity Act 1989 (and the Electricity (Northern Ireland) Order 1992) and the Railways Act 1993. The tax will be charged on the floated companies.

How the tax is calculated

2. The taxable amount will be the difference between company value, calculated by reference to

average annual profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation.

3. Company value will be calculated by multiplying average annual profits after tax over the period by a price/earnings ratio of 9. The value placed on the company at the time of flotation will be calculated by multiplying the ordinary share capital of the company at flotation by the price at which shares were offered to the financial institutions at flotation.

4. Profits after tax figures will be derived from accounts drawn up under the rules set out in the Companies Act 1985. Where consolidated accounts are drawn up figures from those accounts will be used. The price/earnings ratio of 9 approximates to the lowest average price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector.

5. The period will be the first four financial years of the company beginning after flotation and ending before 1 April 1997. Where flotation took place too recently for four financial years to be completed, the period will cover financial years ending after flotation and before 1 April 1997. Where a financial year straddles flotation only the profits of the part of the year following flotation will be taken into account, on a time apportioned basis.

6. The charge to tax will arise on Budget day and the rate will be 23 per cent.

7. Where 85 per cent or less of the ordinary share capital of a company was offered for sale at the

flotation of the company only the appropriate proportion of both

- company value by reference to the average profits after tax,
- and the value placed on the company at the time of flotation,

will be taken into account in calculating the taxable amount. The appropriate proportion will be that which the shares offered for sale at flotation bear to the ordinary share capital of the company at that time.

8. There will also be rules to allocate the tax liability between companies which have demerged under statutory schemes. The allocation will be on the basis of the respective market capitalisations of the companies at the time of the demerger.

9. The tax will not be deductible in computing a company's liability to corporation tax and it will not be possible for a company to set advance corporation tax against liability to windfall tax.

Administration of the tax

10. The tax will be centrally administered by the Inland Revenue.

11. The tax will be payable in two equal instalments on or before 1 December 1997 and 1 December 1998. Interest will be payable on tax paid late and on repayments of overpaid tax.

12. Each company liable to windfall tax will be required to make a return to the Inland Revenue, including a computation of its liability, by 1

December 1997 (the date when the first instalment of the tax is due). If not issued with a return a chargeable company must notify the Inland Revenue of its liability to the tax by that date.

13. Assessments to windfall tax will be made by the Inland Revenue. Where the amount of the liability is disputed there will be a right of appeal to the Special Commissioners.

14. Penalties will be charged where companies fail to comply with their obligations to notify liability or make a return, or where they make a return or supply information which is incorrect.

15. Where a company fails to pay the tax the Inland Revenue will be able to recover the tax from other companies in the same group as the defaulting company.

Profit Related Pay

16. The rules relating to the calculation of profits for the purposes of profit related pay (PRP) will be amended to take account of the windfall tax with effect for all profit periods ending on or after today. This will enable the companies concerned, if they choose to do so, to calculate their employees' PRP on their profits before deducting windfall tax.

NOTES FOR EDITORS

1. The companies falling within the scope of the windfall tax are BAA, British Energy, British Gas (now BG plc and Centrica), British Telecom, National Power, Northern Ireland Electricity, Powergen, Scottish Hydro, Scottish Power and Railtrack, the regional electricity companies and the privatised

water and sewerage companies (including such companies now forming part of Hyder, United Utilities and Scottish Power) .

2. A separate press release "Welfare to Work" covering the windfall tax, and the programme which it will fund, is being issued today by HM Treasury.

EXHIBIT 45-P

BOARD OF INLAND REVENUE

RESOLUTION 1

SUMMER FINANCE BILL 1997

CLAUSE 1 / SCHEDULE 1

HM TREASURY

(JULY)

EXPLANATORY NOTE

CLAUSE 1 - CHARGE TO WINDFALL TAX

SUMMARY

1. The clause imposes the charge to the windfall tax, at 23 per cent, on companies which, on Budget Day, were benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation.

2. The schedule defines the amount of a company's windfall as the difference between its value, calculated by reference to its profits after tax in a period of up to four years following privatisation and the value placed on it at the time of its flotation.

DETAILS OF THE CLAUSE AND SCHEDULE

THE CLAUSE

3. Subsection (1) provides that any company which, on 2 July 1997, (Budget Day), was benefitting from a windfall from the flotation of an undertaking whose

privatisation involved the imposition of economic regulation shall be charged to windfall tax.

4. Subsection (2) sets the rate of windfall tax at 23 per cent.

5. Subsection (3) applies Schedule 1 which sets out how the amount of a company's windfall is to be calculated.

THE SCHEDULE

6. Paragraph 1 provides the basic rule for calculating the liability of a company charged to the windfall tax.

7. Sub-paragraphs 1(1) and 1(2) provide for the calculation of the taxable amount payable by a chargeable company. The taxable amount is calculated by taking the value of the company in profit-making term and deducting the value placed on the company at the time of flotation.

8. Paragraph 2 defines the value of the company in profit-making terms.

9. Sub-paragraph 2(1) provides that the value of the company in profit-making terms is calculated by multiplying the average annual profit for a company's initial period by the applicable price-to-earnings ratio. Initial period is defined in paragraph 6 of the schedule.

10. Sub-paragraph 2(2) sets out the formula for calculating the average annual profit for the initial period as:

$$A = 365 \times \frac{P}{D}$$

where A is the average annual profit for the initial period

P is the total profit for the initial period

D is the number of days in the initial period.

11. Sub-paragraph 2(3) sets the price-to-earnings ratio as 9. This' figure approximates to the lowest average sectoral price-to-earnings ratio of the companies liable to the tax.

12. Paragraph 3 defines the value placed on the company at the time of flotation for privatisation purposes.

13 Sub-paragraph 3(1) provides that, subject to paragraph 4 of the schedule, the value placed on the company at the time of flotation is calculated by multiplying the institutional price by the number of shares comprised in the company's ordinary share capital at the time of flotation.

14. Sub-paragraph 3(2) defines institutional price as the highest fixed price per share at which publicly-owned shares in the company were offered for disposal at its flotation.

15. Sub-paragraph 3(3) provides that, where publicly-owned shares offered for disposal at the flotation of the company could be purchased under an instalment arrangement, the price per share is the aggregate of the instalments.

16. Sub-paragraph 3(4) prevents any discount from being taken into account in determining the price per share.

17. Paragraph 4 deals with cases where companies were privatised in stages.

18. Sub-paragraphs 4(1) and 4(2) provide that where 85 per cent or less of the ordinary share capital of a company was disposed of at flotation.

- the value of the company in profit-making terms; and
- the value placed on the company at the time of flotation

are to be reduced to the disposal percentage. The disposal percentage is the percentage of the ordinary share capital which was disposed of at flotation.

19. Paragraph 5 explains what is meant by the total profits for the initial period.

20. Sub-paragraphs 5(1) and 5(2) define the amount of a company's total profits for its initial period as the sum of the profit figures shown in the relevant accounts for each of the financial years ending in, or at the end of, its initial period. Where group accounts have been prepared in accordance with section 227 of the Companies Act 1985 for any of those financial years, the profit figure to be used is the sum of the profits of that company and its subsidiary undertakings. In any other case the profit figure is the profit of that company for that year.

21. Sub-paragraph 5(3) covers the situation where a company's financial year straddles the beginning of its initial period. It requires an apportionment to be

made on a time basis of the profits for that financial year, so that only those profits attributable to the initial period are taken into account.

22. Sub-paragraph 5(4) covers the situation where accounts have been drawn up on a current cost accounting basis but information provided with the accounts indicates what the profit would have been if the accounts had been drawn up on an historic cost accounting basis. In these circumstances the profit to be used is that calculated on the historic cost accounting basis.

23. Sub-paragraph 5(5) provides that accounts are to be those delivered to the registrar under section 242 of the Companies Act 1985. If a company was a parent at the end of a financial year, those accounts will be consolidated group accounts prepared in accordance with section 227 of the Companies Act. In any other case, they will be accounts prepared in accordance with section 226 of the Companies Act. "Registrar" is defined in paragraph 5(11) of the schedule.

24. Sub-paragraph 5(6) defines the profit for a financial year as the profit figure required to be shown as the final item in the profit and loss account in the statutory format used. "Statutory format" is defined in paragraph 5(11) of the schedule.

25. Sub-paragraph 5(7) provides that any provisions or deductions made in accounts in relation to the Windfall tax or in anticipation of the imposition of a similar charge are to be added back.

26. Sub-paragraph 5(8) makes clear that where accounts used in calculating the taxable amount are

not delivered to the registrar until after Budget Day the charge to windfall tax is still to be treated as arising on that day. Similarly, the date on which accounts are delivered to the registrar does not affect the requirement to pay an instalment of windfall tax, or any other liability in connection with the tax. The sub-paragraph also ensures that the power of the Board to make assessments is not prejudiced by the late submission of accounts.

27. Sub-paragraph 5(9) ensures that where various sections of the Companies Act 1985 were amended by the Companies Act 1989 the appropriate form of those sections applies at the relevant times.

28. Sub-paragraph 5(10) applies the provisions of the paragraph to Northern Ireland by reference to the appropriate articles of the Companies (Northern Ireland) Order 1986.

29. Sub-Paragraph 5(11) defines "registrar" and "statutory format".

30. Paragraph 6 explains the meaning of the initial period.

31. Sub-paragraph 6(1) defines the initial period as the first four financial years of a company beginning after flotation.

32 Sub-paragraph 6(2) defines the initial period for a company privatised too recently to have four financial years beginning after flotation and ending before 1 April 1997. For such a company, the initial period begins on the day of flotation and ends with the final day of its last financial year ending before 1 April 1997.

33. Paragraph 7 supplies rules for apportioning the taxable amount between demerged successor companies and their predecessors.

34. Sub-paragraph 7(1) applies the apportionment rules where a predecessor company and its demerged successor are both benefitting from a windfall from flotation on 2 July 1997.

35. Sub-paragraphs 7(2) to 7(5) apportion the taxable amount between the two companies. This is done by reference to the market capitalisation of the two companies at the close of trading on the Stock Exchange on the day the shares of the demerged successor were first listed on the Official List of the Stock Exchange. The fraction.

$$\frac{P}{P+S}$$

is applied to the taxable amount and that fractional amount is treated as the taxable amount of the predecessor and the remainder as the taxable amount of the demerged successor. In this formula:

P is the number of shares in the ordinary share capital of the predecessor company at the end of the relevant day multiplied by the average of the two closing prices shown in the Stock Exchange Daily Official List for that day.

S is the number of shares in the ordinary share capital of the demerged successor company at the end of the relevant day multiplied by the average of the two closing prices shown in the Stock Exchange Daily Official List for that day.

36. Paragraph 8 explains how terms used in the schedule are to be interpreted.

37. Sub-paragraphs (1) and (2) define "financial year".

38. Sub-paragraphs (3) and (4) define shares offered for disposal on a company's flotation as those included in the offer to the public and any other publicly-owned shares that were included in an offer for disposal at that time.

39. Sub-paragraph (5) provides for the treatment of bonus shares, in calculating a company's disposal percentage under paragraph 4 of the schedule where bonus shares are part of the offer, but no provision is made within the offer for the shares needed to meet the bonus entitlements. In such circumstances, the shares offered for disposal on flotation are to be treated as including shares actually distributed before 2 July 1997 to satisfy those bonus entitlements. This situation generally arises where companies were privatised in stages and the bonus entitlements were met out of the shareholding which remained in public ownership.

40. Sub-paragraph (6) defines ordinary share capital.

BACKGROUND

41. The introduction of the windfall tax is in accordance with the commitment in the Government's Election Manifesto to raise a tax on the excess profits of the privatised utilities.

42. The profits made by these companies in the years following privatisation were excessive when

considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.

43. The windfall tax will raise around £5.2 billion and fund the Government's welfare to work programme.

CLAUSE 2 - THE COMPANIES BENEFITTING FROM WINDFALLS

SUMMARY

1. This clause defines the companies charged to the windfall tax as companies, or demerged successors of companies, which

- received property, rights and liabilities of a public corporation by a statutory transfer,
- were subsequently privatized by flotation; and
- were regulated at the time of flotation (or had a subsidiary regulated) under certain privatising statutes;

2. The relevant privatising statutes under which chargeable companies must have been regulated are listed in the clause.

DETAILS OF THE CLAUSE

3. Subsection (1) provides that a company in existence on 2 July (Budget Day) is treated as benefitting on that date from a windfall from flotation if

- the company, or a company of which it is a demerged successor, had before 2 July 1997 been privatised by means of flotation;
- prior to flotation there had been a statutory transfer of property, rights and liabilities from a public corporation to the floated company or to a subsidiary of that company at the time of flotation;
- at the time of flotation the company was carrying on an undertaking whose privatisation involved the imposition of economic regulation.

4. Subsection (2) defines the term "privatised by means of a flotation" as involving:

- an offer of publicly-owned shares in the company to the public in the United Kingdom at a fixed price;
- the first admission of shares in the floated company to listing on the Stock Exchange Official List in connection with the offer.

5. Subsection (3) defines the time of a company's flotation as the time when shares in the floated company were first admitted to listing on the Official List of the Stock Exchange.

6. Subsection (4) defines what is meant by a "demerged successor of a company privatised by means of a flotation». A company is within the definition if

- on 2 July 1997 it had a subsidiary which had previously been a subsidiary of a company privatised by means of flotation;

- if after the flotation, but before 2 July 1997, that subsidiary (the "transferee company") had received property rights and liabilities from the floated company, under a statutory transfer which had occurred while it was still a subsidiary of that company;
- before 2 July 1997 shares in the company were admitted to listing on the . Official List of the Stock Exchange as a result of an application made in connection with the transaction(s) by which the transferee company ceased to be a subsidiary of the floated company.

7. Subsection (5) defines a company which, at the time of its privatization, was carrying on an undertaking whose privatisation involved economic regulation. This is a company which {or a subsidiary of which) is

- a public telecommunications operator within the meaning of the Telecommunications Act 1984;
- an airport operator in relation to an airport subject to economic regulation under Part IV of the Airports Act 1986;
- the holder of an authorisation granted under section 7 of the Gas Act 1986, as originally enacted (public gas suppliers);
- the holder of an appointment under section 11 of the Water Act 1989 as the water undertaker for any area of England and Wales;
- the holder of a licence under section 6 of the Electricity Act 1989 or Article 10 of the Electricity (Northern Ireland) Order 1992 (licences

authorizing generation, transmission and supply of electricity); or

- a company authorised under section 8 of the Railways Act 1993 to be the operator of a railway asset .

8. Subsection (6) provides that "airport operator" has the same meaning as in the Airports Act 1986.

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EXHIBIT 48-P
THE U.K. PARLIAMENT
PARLIAMENTARY DEBATE OF
U.K WINDFALL TAX

July 15, 1997

Orders of the Day

Finance Bill

(Clauses 1, 15, 17 and 19) *Considered in Committee.*

[Sir Alan Haselhurst in the Chair]

Clause 1

Charge to windfall tax

Question proposed, That the clause stand part of the Bill.

Mr. Peter Lilley (Hitchin and Harpenden) rose—

The Paymaster General (Mr. Geoffrey Robinson): I see that the shadow Chancellor is in some doubt as to whether he or I should speak first. Are you prepared to rule on who should speak first, Sir Alan? Perhaps you could also enlighten us on whether there are any amendments for us to discuss. The Opposition may already have decided that they will not oppose clause 1, or, indeed, the Bill as a whole.

I am at a loss. It is some time since I have served on a Committee of the whole House, but normally

amendments are tabled—sometimes, in extremis, starred amendments. It is, in my experience, unique for us to find that there are no amendments for us to discuss. Should I move that the clause stand part of the Bill, Sir Alan, or do you recommend some other procedure?

The Chairman of Ways and Means (Sir Alan Haselhurst): This may be a first occasion for many of us. It is the first occasion on which I have chaired a debate on the Finance Bill, just as it is the first occasion on which the Paymaster General has opened such a debate. I have, however, already put the Question, so the debate will take place on clause stand part.

It is fairly unusual for a Minister almost to solicit amendments to one of his clauses. Having looked to see who had risen, I saw the Paymaster General and did him the courtesy of calling him first.

Mr. Robinson: I am grateful to you, Sir Alan. We can take it, then, that the Opposition could not table an amendment that was in order, but still intend to offer some sort of latter-day attack on the windfall tax.

Clause 1 heads a group of provisions that together introduce the windfall tax, thus meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities. Those companies were sold too cheaply, so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatisation was too lax, so the customer got a bad deal.

As a result, the companies were able to make profits that represented an excessive return on the value placed on them at the time of their flotation. We are now putting right the failures of the past by levying a one-off tax. The yield of around £5.2 billion will fund our welfare-to-work programme, and the new deal that we have announced for the young long-term unemployed and schools.

Clause 1 provides a one-off charge, set at a rate of 23 per cent. It also gives effect to schedule 1, which will be debated in Standing Committee. It may be helpful if I set the clause in context by explaining briefly how the windfall tax works.

Windfall tax is charged on the difference between the value of the company, calculated by reference to the profits made in the initial period after privatisation, and the value placed on the company at the time of privatisation. The value of the company is calculated by multiplying the average annual profit after tax for, normally, the first four financial years after flotation, by a price-to-earnings ratio of nine. That ratio approximates to the lowest average—

Mr. Lilley: Will the Minister give way?

Mr. Robinson: In one second. I shall just finish this point.

If the shadow Chancellor wants to intervene on the ratio, it may be helpful for him to know that the ratio approximates to the lowest average sectoral price-to-earnings ratio of the companies liable to the tax. The value placed on the company at flotation is calculated by multiplying the number of ordinary shares by the

price at which shares were offered to financial institutions.

Mr. Lilley: I think that the Minister has kindly answered the question that I was about to ask, which was simply: whence did he pluck the figure nine? On reading Hansard, I shall be able to investigate exactly where he got the figure from.

Mr. Robinson: I am grateful to have so easily assisted the shadow Chancellor. May that ease continue as we proceed into more difficult waters during proceedings on the Bill.

Tax will be charged on that amount at 23 per cent. The tax will be payable in two instalments, due on 1 December 1997 and 1 December 1998. The companies liable to the windfall tax are those that were privatised by flotation and subject to economic regulation. That links with the rationale of the tax; the companies were sold off too cheaply when their shares were offered under value on flotation, and were regulated too loosely in the initial period after privatisation.

We have wasted no time in introducing the legislation and in fulfilling our electoral pledge. I commend the clause to the Committee.

Mr. Lilley: That was hardly a ringing endorsement of clause 1, and I can set the Minister's mind at rest: we have every intention of opposing this and subsequent clauses vigorously, both today and in Standing Committee. We have tabled amendments which, by definition, were in order because they are on the amendment paper. However, you have rightly decided, Sir Alan—all your decisions are right—not

to select the amendments and that we can cover this ground under clause stand part, and that is what I intend to do.

Clause 1 introduces the only tax, out of the 17 tax increases imposed by the Budget, which does not breach promises in the Labour party's manifesto. If the House recalls, Labour promised that it had no need for any taxes over and above the windfall tax; it did tell the nation that there was to be a windfall tax, and it was in the manifesto. However, even that tax was based, essentially, on a deception: the pretence that it would not be paid by ordinary people. It was to be a sort of victimless crime, or rather a fine on the guilty—the so-called fat cats and the speculators—or on some abstract entity, the utility companies.

We have four major criticisms of the clause and the windfall tax that it initiates. First, the clause makes it clear that the tax will not be borne by the so-called fat cats and speculators, criticisms of whom justified its introduction. Secondly, it makes no meaningful attempt to define what is a windfall and should therefore bear the tax. Thirdly, it increases instead of reduces cost to customers; any improved profitability should be passed on to customers in the form of lower prices. Finally, it is retrospective, arbitrary and symptomatic of the Government's belief in arbitrary government, rather than in government by known and predictable rules.

The first issue, therefore, is who will pay the tax in the first instance. I should like the Minister to confirm that next to nothing will be paid by the people whom Labour spent many years vilifying—the so-called fat cats. How much of the tax will be paid by

directors of privatised utilities? Next to nothing, I venture to suggest. How much will be paid by the notorious Cedric Brown? Not a penny, I suspect. Nor will it fall upon the so-called speculators, if the definition referred to in the clause is incorporated in the Bill. Virtually no one who subscribed early and sold immediately—who stagged the market—or sold within a brief period afterwards will pay any of this tax. Yet those who bought the shares after flotation, for long-term investment—on behalf, usually, of pensioners—will pay the tax in full; unless, of course, it is passed to their customers.

Mr. George Stevenson (Stoke-on-Trent, South): Would the shadow Chancellor care to comment on the obscene procedure that applied when National Grid was given away, when regional electricity companies received windfalls of hundreds of millions of pounds at public expense, without lifting a finger?

Mr. Lilley: My recollection is that that resulted in £50 being knocked off every quarterly electricity bill in the country. The hon. Gentleman may think that that is obscene. We think that that is what privatisation is all about—reducing costs and prices and passing the benefits to consumers.

Mr. Dale Campbell-Savours (Workington): May I ask the shadow Chancellor a simple question? Has it dawned on him that one of the reasons why millions of people changed their vote at the election was that they believed that the Conservatives represented and condoned greed? Does not this debate derive in essence from that greed, which the Opposition failed to control when they were in government?

Mr. Lilley: This may surprise the hon. Gentleman, but there is undoubtedly an element of truth in what he says. That is why I have no doubt that he will share my criticism of his Front-Bench colleagues for erecting a superstructure of criticism on the basis of the alleged greed of the directors of those companies, to justify the imposition of a tax which, according to the Bill, will not fall on those people of whom the hon. Gentleman and my right hon. Friend the Member for Huntingdon (Mr. Major), the former Prime Minister, were critical. The hon. Gentleman has highlighted the very weakness in the clause that I am seeking to highlight.

The clause says:

> 'Every company which, on 2nd July 1997, was benefiting from a windfall from the flotation ... shall be charged with a tax ... on the amount of that windfall.'

The company, of course, is the shareholders at any point in time, but the so-called windfall arose in many cases a decade or more ago. If there was a windfall, it may have been paid out in dividends to the shareholders who held the shares in the intervening period.

How can it be meaningful in the clause to describe shareholders on 2 July 1997 as "benefiting from a windfall", which may have arisen years before and which may have been paid out in dividends to a previous generation of shareholders? Will not the clause be open to legal challenge, as it is internally contradictory? Will the Paymaster General explain why he did not put that benefit in the past rather

than the present tense, when clearly the definition in the schedule relates to alleged excess profits arising many years before?

That brings me to my second set of concerns. What do the Government mean by a windfall? No serious attempt is made to define anything that could be meaningfully defined as a windfall. Most people would assume that it referred to the rise in the share price soon after flotation. Previously, informed sources—who appeared to have the ear of the Labour party—made it clear that Labour intended at that time to relate the tax to movements in share prices after flotation.

Why did not the Labour party proceed down that route? Was it because the burden of tax would have fallen more heavily on the companies that were wooing the Labour party at that time? Or was it because that approach would have made it all the more obvious that it was essentially unjust to levy a tax on today's shareholders, which related to gains that accrued to a previous set of shareholders—a tax that would by definition not fall on those who realised those gains before the tax was introduced?

Instead, the Government have come along and defined excess profits arbitrarily. They have taken average profits over four years after flotation. If those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess. The factor of nine seems to have been plucked from the air. If I heard the Minister correctly, he said that it was related to the lowest price-to-earnings ratio.

Mr. Geoffrey Robinson: The shadow Chancellor was kind enough to say that I had been clear with him. I apologise if I was not. I think that I was. It is the lowest sectoral price-to-earnings ratio, which was 9.2 for water. We have rounded that down to nine. Is the shadow Chancellor saying that we should take a higher price-to-earnings ratio in calculating the windfall tax? Many sectors and companies had much higher price-to-earnings ratios in the relevant period.

Mr. Lilley: There are not many companies in Britain with which to make comparisons. Why does the Minister not compare more widely, say, with utility companies floated on the American stock exchange? From my recollection, which is hazy with the passage of time, the price-to earnings ratios of those utilities are more like six than nine. It seems odd to say that anything above the norm is an excess that should be taxed. There is in any marketplace a range around the norm, which reflects the different degrees of success of companies. It is odd not to allow for that fact.

Mr. Robinson: Will the right hon. Gentleman give way?

Mr. Lilley: In a second. While the Minister is about it, perhaps he could tell us why he chose four years after flotation rather than three, five, 10 or two.

Mr. Robinson: Four years broadly corresponds with the first period of price regulation, when regulation was lax. It seemed appropriate to encapsulate the profit that arose in part from the undervalue at sale and in part from the lax regulation in the first period of price regulation.

I fear that I still have not made it clear to the right hon. Gentleman why we have taken the factor of nine. The windfall gain is not that in excess of nine, but that measured between the funds realised by the sale of shares on flotation day and the application of nine—which is the lowest—to the profits. We could not be fairer on any account.

Mr. Lilley: I am not sure that everyone will agree with that. Most people would regard as fairer a number that reflected what was excessive rather than what was just above the normal.

Essentially, the windfall tax boils down to a tax on success. Companies that failed to improve their profitability over the said period will pay much less or even no windfall tax. Some companies are complaining that other companies in the same industry that were conspicuous failures in modernising, improving and increasing their profitability and efficiency will pay little tax, while those that have done most to invest, reform their working practices and diversify into other businesses will pay most.

I understand that companies that have diversified into new ventures, even if outside the regulated activities, will pay windfall tax on the benefits of diversification. I stand open to correction by the Minister if that is not the case. As he does not correct me, I assume that I am correct and that the Government will impose a windfall tax on profits made in areas other than those in which the company was operating at the time of privatisation and other than in directly regulated areas. That is an indication that the Labour party has not changed.

The Labour party still believes that profit is a dirty word. The more profits people make, the dirtier they are and the bigger the tax they should have to pay. That is the essence of the proposal before us.

The Government simply do not understand what privatisation was for or how the regulatory system was intended to pass on the benefits to customers. The aim was to harness the profit motive, which was conspicuously lacking under nationalised ownership, to improve efficiency and reduce prices to the customer. Given the monopoly position of many of the industries involved, some regulatory system was essential to ensure that companies did not improve their profits simply by raising their prices.

We could have chosen a system of fixed profit margins. That has been tried in some countries, but it is grossly inefficient because it leads to cost-plus pricing: the more the company's costs increase, the higher its prices. It is automatically allowed to pass costs on by the regulator. We therefore did not choose that method. We could have gone for a rate-of-return system, which is often used in North America and elsewhere, but that, too, leads companies to wasteful, gold-plated investment. They automatically earn a higher return the more they invest, which leads to inefficient use of resources.

We initiated and developed—it has since been copied elsewhere—the so-called RPI minus X system, which requires companies to reduce their prices in real terms by fixing price increases at X points less than the rise in the retail prices index. That requires companies to reduce their prices. If a company cuts its costs even faster than it reduces its prices, it can

improve its profits. However, after a fixed period—the Minister gave an average of four years—the RPI minus X system is revised in the light of performance, so that the benefit of past efficiency gains is passed on in lower prices in the next term.

There is a sharper spur for further gains in efficiency, as companies can make higher profits only by exceeding that even more demanding price reduction target. If the Government can convince the House that more than adequate profits are being earned by any of the industries concerned, they or the regulators should require at the next price review bigger reductions in prices, and faster falls in prices thereafter, to ensure that the benefits are passed on to the customer. It is the customer, not the tax man, who should benefit from the efficiency that privatisation has brought.

Lorna Fitzsimons (Rochdale): The shadow Chancellor should be aware that the water regulator, Ian Byatt, has pledged that his current pricing review will mean direct reductions in prices for customers, taking account of the windfall tax, in the next five-year retail prices index calculation.

Mr. Lilley: Exactly. The hon. Lady has hit it on both buttons. First, the regulator will automatically pass on efficiency gains, and, secondly, he will take the windfall tax into account. The reduction will be less than it would have been had it not been for the windfall tax. She has made for me my very next point. Because the Government are imposing an extra cost on these industries, the reduction in prices will not be as great, or will not occur at all.

We should not underestimate how effective privatisation has been in reducing costs to consumers, both domestic and industrial. Since privatisation, telecoms prices have fallen by 40 per cent. in real terms. As a result, calls are cheaper than in France, Germany or Italy. Gas prices have gone down 20 per cent. for domestic consumers and, for domestic consumers, are below those of Germany, France, Italy, the Netherlands and Belgium. The price of gas for industrial users has fallen by 48 per cent. There has been a reduction of 9 per cent. in the price of electricity for domestic consumers, and one of 10.5 per cent. for businesses. Generators have doubled their productivity since privatisation. That is an indictment of the failures of nationalisation and a recommendation of the success of privatisation since we introduced the policy.

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Mr. Cranston: Conservative Members have raised various points about the unfairness of the tax. They have said that it is unfair to some utilities rather than to others. The regional electricity company in my area has put that argument to me. It has pointed out that other such companies have engaged in expensive diversifications. Money was wasted, but the effect is that the company's profits are higher than those of the companies that diversified. The Institute for Fiscal Studies made the point, which was repeated by Conservative Members, that many of the people who gained immediately after the privatisation have moved on, and that is true, but Conservative Members have to take into account that, in imposing a tax, there is a need for simplicity.

In tax law, there is always a tension between simplicity and producing absolute fairness. The Government have rightly taken the approach of a simple formula, as set out in the schedule. Any other approach would open opportunities for avoidance. In this morning's Financial Times, the former tax adviser to the right hon. and learned Member for Rushcliffe (Mr. Clarke) makes this point:

> "Successively more complex sets of rules have been created. which in turn provide opportunities for exploitation. A simpler tax system, with fewer reliefs, exemptions and discontinuities would, in the long term, frustrate most of the tax avoiders' ploys."

The Government have taken the view that the simple formula is the right approach, and I agree.

Having listened to the contribution of the hon. Member for Grantham and Stamford (Mr. Davies) to the debate, one would think that the sky had fallen in. There is much hyperbole. He said that there had been a decline in the economy. I am not sure that anyone else has seen that. The fact is that the windfall tax is water under the bridge. It is a popular tax. Its imposition has been legitimised by the country as a whole. The movement in utility share prices demonstrates that the utilities accept the tax as a fact of life. Frankly, it is not as high as was expected. Most important, uncertainty—inasmuch as there was uncertainty—about its impact has been removed. As we predicted, balance sheets are strong enough to cope with the tax. Informed commentary is that it will generally not have an impact on future dividend plans.

My right hon. Friend the Chancellor of the Exchequer has said that the tax should not have an impact on prices, and that must be the case: consumers must not suffer twice round. I made that point on Second Reading and I reiterate it. I hope that the steps taken by my right hon. Friend the President of the Board of Trade will ensure that the tax does not lead to price increases for consumers.

Conservative Members have generated much hot air. There is much hyperbole. The tax is legitimate, and I support its introduction.

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Mr. Lilley: The principal argument for the tax has been that the shares were undervalued at the time of issue. I was a humble and junior Minister at the time, but I can say from my experience in the Treasury that we wanted and needed every penny that we could get of the revenues from the privatisations of those companies. We certainly did not deliberately let them go at a price significantly below their market value. We took professional advice from officials within the Treasury and we took the best professional advice that money—a lot of money—can buy in the City. There was a range of opinions: in the only privatisation in which I was involved, I argued for a higher share price than the officials advised. But to suggest that there was a difference of 100 per cent. between the real value and the price set is nonsense.

The value could be set only on the basis of past experience. We did not know the future; we did not have perfect foresight, but had to relate the price to

past profits. It would be logical to relate the relative undervaluation—if there is one—of the price at issue to some multiple of past profits, but not future profits. It is the very success of the privatisations—the fact that they exceeded our expectations—that created bigger profits.

What about Jaguar? I cannot remember whether the Paymaster General was around at the time of its flotation. Was he around at that time? Was he involved in it? Was that flotation underpriced? Did it sell at a premium? Did the Paymaster General benefit? Should he pay us a sort of voluntary windfall? Was the price a sign that the management had deliberately undervalued the company for some extraordinary reason?

BP was the first privatisation; it was started by the previous Labour Government at the behest of the International Monetary Fund. A majority of the shares were held by the Government, who sold some. A profit was made and the shares are now at a much higher price than they were when they were sold off by the previous Labour Government. Indeed, some Labour Ministers have holdings in the company. Based on the principle that present holdings should be taxed for the gains previously made by people who now have nothing to do with the company, presumably a large tax should be paid on those holdings. It is lucky that we know about those holdings—although we nearly did not.

The debate has been extremely helpful in revealing that the tax is without logic or foundation. It sets a dangerous precedent, and is an appallingly long

retrospective tax. We urge the Government to think again about it.

Today's debate is not about the merits or otherwise of the welfare-to-work programme, which does not appear in the clause. We have debated the merits of that programme on previous occasions. If the programme is valid, it should be financed by proper, not retrospective taxation; it should be financed by continuing, not one-off taxes that threaten gradually to become permanent; and it should be financed by taxes that allow everyone to see who ultimately pays. We know who will pay: households and pensioners will pay the cost of Labour's windfall tax.

Mr. Geoffrey Robinson: This debate has been about anything but clause 1. The shadow Chancellor, the right hon. Member for Hitchin and Harpenden (Mr. Lilley), must realise that he has not mentioned any aspects of clause 1. The debate has been illuminating for the right hon. Gentleman, as we have been able to explain to him the tax profit base, how it is calculated, the price-to-earnings ratio, and why we have taken the first four years. The right hon. Gentleman did not express a view on any of those matters, although he can see the logic of the tax.

The tax is logical. We are able to define the criteria that determine which companies will be affected. We have been able to use a ratio that is well established in the financial markets. The right hon. Gentleman and other Conservative Members know from their experience in previous occupations that it is clearly not an arbitrary tax. It consistently taxes all the

companies that fall under the definition and treats them consistently in every respect.

The tax is not arbitrary, because we have focused on a period of four years and measured the excess profits over that period. That is why, throughout the debate, Conservative Members have had to re-hash the arguments that they advanced on Second Reading. We have not heard any discussion among Conservative Members about the basis of the tax. They have not attacked it on a technical, legal, or even financial level. All we hear are the same old adjectives trotted out.

Mr. Nick Gibb (Bognor Regis and Littlehampton): Will the Paymaster General give way?

Mr. Robinson: It is interesting that the hon. Gentleman is trying to intervene now, when just 14 minutes remain and I have many hon. Members to respond to. He was given an opportunity to contribute by you, Mr. Martin, as the last Labour Member finished speaking, but he was so hesitant and tentative that he was overlooked. I shall give him an opportunity to contribute now.

Mr. Gibb: As the windfall tax is unlikely to be a creditable tax for United States double tax relief purposes because it is a tax on capital rather than income, and as the US is such a large investor in the United Kingdom, particularly in the utilities sector, will the Paymaster General tell us what discussions the Government have had with the US Government to ensure that the US Government do not impose a retaliatory tax on UK investors in the US?

Mr. Robinson: As the hon. Gentleman well knows, that question is one for the US authorities; it is not for us to intervene in any decision that they reach on that matter. As the hon. Gentleman is so concerned about the attitude of American companies to our utilities—a point raised by the hon. Member for Grantham and Stamford (Mr. Davies), who has just returned to the Chamber—he will be interested to know that, far from uncertainty being created in the marketplace, shares have risen, as the shadow Chancellor readily conceded. In fact, the American PacifiCorp bid for the Energy Group, which includes Eastern Electricity, has been tabled and still remains active at £3.6 billion.

That is another sign of the markets' confidence in the Labour Government.

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Mr. Robinson: The hon. Member for East Yorkshire (Mr. Townend), who is not with us now, referred to East Midlands Electricity and Yorkshire Electricity. We are not trying to favour one company against another. It is not a question of trying to be fair to some and unfair to others. Profits that were made in those four years and profits that were made against the price at which the companies were floated, represent what we judge to be excess profit, and if that is higher for East Midlands than for Yorkshire, I am afraid that that is how it is. The shareholders of the company that has done better will have shared in that success. We are now rightly trying to get back some of that success for all taxpayers, who have not benefited from it.

My hon. Friend the Member for Dudley, North (Mr. Cranston) concisely and accurately described how the tax is intended to work and why it will work on that basis. The problem with the Liberal Democrats, on the other hand—this applies as much to the hon. Member for Gordon as to the hon. Member for Portsmouth, South (Mr. Hancock)—is that they cannot make up their minds. They will the end, but they cannot bring themselves to will the means. That is the problem. Nothing in their manifesto would come near to raising sums of the magnitude of those that this tax—presented to and voted for by the electorate—will raise. The Liberal Democrats cannot say yes to the programmes but no to the tax. That is their usual position—standing on their heads.

My hon. Friend the Member for Stoke-on-Trent, South (Mr. Stevenson) accurately calculated the likely excess profits to be about £6 billion, which he said had been calculated on a modest basis. I have already explained to the Committee that the basis of the tax—setting the price-to-earnings ratio at nine, slightly below the lowest sectoral average—shows a Government who are trying to be reasonable and fair in all respects.

The question of unfairness and uncertainty was brought up again by the hon. Member for Witney (Mr. Woodward), and it seems ironic that unfairness and uncertainty can be brought to bear when the clearest possible criteria and the clearest possible objective basis for the tax have been established, have been unchallenged by the Opposition and have been applied impartially to the companies that meet the criteria that we have established.

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Mr. Geoffrey Robinson: The figure of nine is not arbitrary; it is meant to be as fair as possible to the companies involved. We analysed the relevant PEs for the companies in the relevant period in which windfall profits will be taxed, and the lowest we could find was—if my memory serves me right—9.2 for water companies. Therefore, it seemed fair to take a figure below that to show that we were not seeking to introduce a tax that would penalise them. We are trying to be fair and reasonable in the circumstances.

In other circumstances, one might be tempted to accept the amendment, but the result would be a tax charge of more than £17 million on the companies. If we did what the right hon. Member for Wells (Mr. Heathcoat-Amory) suggests, we would impose a PE of more than 17 because of the present FT index of utilities. As the right hon. Gentleman rightly said, a balance was struck between the rate at which the tax should be charged on one hand and the PE ratio on the other. We decided to fix the PE at a fair point—I think that, on reflection, the right hon. Gentleman will agree about that—and to fix the rate of tax at a point at which we felt the companies could bear that reasonably corresponded to the windfall that they had generated.

The result is that the total yield is £5.2 billion, which is in line with what the market was expecting. We imagine that the market came to that conclusion by using the same sort of rational criteria that we used, although some people chose different terms by which to measure the windfall tax. The widespread

acceptance of the tax by the companies affected shows that we got it about right.

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Mr. Gibbs: Is it not the very simplicity of the calculations set out in schedule I, which I want to talk about in the substantive debate, that makes the whole tax unfair? The Government have gone overboard in their attempts to keep it simple.

Given that the tax applies to fewer than a dozen companies, and given the huge quantity of tax that is paid by anyone company, surely it is worth a little complexity to give a degree of fairness? The way in which the tax is calulated in the schedule gives rise to enormous unfairness. We have heard about Hyder, but there are countless other examples—for instance, applying the same price-to-earnings ratio to different industries is grossly unfair. Surely the Government could add one or two extra clauses to give different PE ratios; that would not be much more complex, but it would be fairer. The very simplicity makes the tax unfair.

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Mr. Gibbs: The formula in the schedule is a crude method of calculating the value of the companies to be used for the windfall tax. As the hon. Member for Dudley, North said, the Government's aim might be to keep the calculation simple. However, given the few companies involved and the large amount of tax that they will pay and despite what the Paymaster General has said, it is better to ensure fairness than to aim for simplicity and lose the fairness that goes with simplicity.

An example of the arbitrary, unfair nature of the calculation is that of regional electricity companies, to which my hon. Friend the Member for East Worthing and Shoreham referred. The Paymaster General did not respond adequately to my hon. Friend's points. The profits of those companies, as calculated under schedule I. include the dividends that they received from their ownership of National Grid. Those dividends were simply passed straight on to shareholders. The grid was then spun off into the direct ownership of shareholders by means of a dividend in specie. Because of that method of privatisation, National Grid escaped the imposition of this dreadful tax.

However. it seems grossly unfair that the windfall tax should be levied on the regional electricity companies on the basis of profits arising from dividends which they will no longer continue to receive. That goes to the basis of calculating the

"Value of a disposal in profit-making terms"

the heading of paragraph 2 of schedule I. That calculation uses the annual profit "for "the company's initial period", as defined in paragraph 5. which has just been amended by the Government. Taking the average annual profit in the four-year period ignores any changes that there might be to those profits as a result of divestments or acquisitions.

There is no concept of continuing activity in the calculation. Notwithstanding the fact that the Government know that the regional electricity companies have disposed of their shares in National Grid, they still include in calculating the value of the

company under the schedule income streams that they know will not exist when the companies are charged the tax. How can that be a fair method of calculating the capital value of a company? Surely, if hon. Members were to buy a company, they would not agree to that method of valuing it—a method in which a higher value is used even though the income stream that they would be purporting to buy would no longer be part of the company. No independent, arm's-length third party would put such a value on a company, and surely the Government should not propose to do so.

Treasury Ministers have given assurances that the regulators of the industries will ensure that the windfall tax will not feed through into higher prices. However, given that many of the companies involved will need to borrow to pay the tax as quantified under the schedule, how have the Government ensured that borrowing costs will not feed through to higher prices?

Privatisation has been enormously successful. Gas prices have fallen by 20 per cent. and telecommunications prices have fallen by 40 per cent. since privatisation. Indeed, Seeboard, which supplies electricity to Littlehampton in the eastern part of my constituency, has reduced its standing charge from £44 a year to £16, while the unit price has remained at 7.3p since privatisation. Those amounts are expressed in cash terms; if inflation is taken into account, that is an enormous reduction in the price of electricity to people in my constituency and elsewhere.

Southern Water, which supplies water and deals with waste water in my constituency, is about to invest £53 million in a new sewage treatment plant, which is the first substantial waste water investment by the water industry for decades. It has occurred only because of privatisation.

* * *

Mr. Gibbs: How can the Government be sure that the calculation of the windfall tax in the crude manner set out in the schedule will not damage the capital spending programmes? What technical changes to the way in which the utilities are being regulated are proposed?

I make no apology for returning to a point I have raised before on several occasions: the nature of the calculations of the tax set out in the schedule makes it a tax on capital rather than a tax on income. I have already referred to my concern about retaliatory taxes from the United States but I am assured by the Paymaster General that discussions have been held with representatives of the United States Government and that there are unlikely to be repercussions on that front. It would have been helpful if the Paymaster General had told us that when I first raised the matter in the House of Commons some days ago. Perhaps the hon. Gentleman had forgotten about the meeting until his officials reminded him of it.

The way in which the tax is calculated in the schedule causes other technical tax problems. First, where shares in the utilities are held abroad, as they are in many cases, the shareholder will want to

obtain double tax relief on dividends paid up in order to avoid double taxation. The Government seem to ride roughshod over the concept of double taxation, as we saw in clause 19, but because the windfall tax is based on profit and not on the capital value of the company itself, in most overseas jurisdictions the tax will not count as an underlying tax for the purposes of calculating the double tax relief available. As such, the dividend will be taxed abroad without any credit for the windfall tax suffered. The Paymaster General may dismiss that issue as a matter for foreign Governments, but it is a direct consequence of the ill-thought-out nature of the method of levying this tax as set out in schedule 1.

All that the hon. Gentleman has achieved with the methodology is to hand over to foreign jurisdictions through their tax systems the value that should truly belong to the United Kingdom entities and which would have stayed with them if he had thought longer and more thoroughly about the methodology in schedule 1.

Similarly, the non-UK resident shareholders of those utilities are effectively being taxed on the capital gain, which is in breach of most of this country's extensive range of double tax treaties. Have the Government addressed that point? Did they consider the extensive representations made by the Chartered Institute of Taxation, which suggested that both problems could be solved if the method of calculating the tax was a charge based on profit, but charged as a supplementary corporation tax? As we all know, the UK corporation tax is a creditable tax according to most double tax treaties.

* * *

Mr. Green: Both my hon. Friends have made excellent points. The valuation at privatisation clearly had to reflect two things. First, the valuation reflected the history of the companies when they were in the state sector. Unsurprisingly, the Government's proposals admit that those companies instantly became much more profitable in the private sector, which in itself is a tribute to the process of privatisation. Of course, that was opposed root and branch by Labour Members throughout the period.

Secondly, my hon. Friend the Member for Bognor Regis and Littlehampton described another factor that was artificially depressing the price of assets and the potential of all those companies when they were in the state sector. He described precisely how, even with the prospect of privatisation, there was the further prospect, at every subsequent general election, of an incoming Labour Government renationalising the assets and no doubt doing a disservice to the new shareholders. As my hon. Friend rightly said, we have a version of that now. After many years, there is a Labour Government again, and the first thing they try to do—no doubt the first thing they will do—is to damage the value of those companies by introducing confiscatory tax. That is not as bad as renationalisation, which previous versions of the Labour party would have introduced, but it is still damaging and it ensures that the calculations in the schedule that are used to try to establish excess profits must be artificial.

Such a valuation is only half the equation that the schedule uses to try to establish the amount of excess

profit that can be subject to a windfall tax. The other half is what the schedule describes as the "applicable price-to-earnings ratio". We have seen several times that that is, to use the Paymaster General's term, perfectly simple. Indeed, he advocated the benefits of simplicity.

I put it to him that, in this case, it is simplicity to the point of idiocy to try to create a single applicable PE ratio for several companies across a wide range of sectors in different industries. At best, it must be very rough and. as it turns out, it is a completely arbitrary calculation. The Inland Revenue's notes on the Finance Bill explain that the relevant PE ratio is set at nine. They state:

> "This figure approximates to the lowest average sectoral price-to-earnings ratio of the companies liable to the tax"

That is about one stage up from sticking one's finger in the air to see which way the wind is blowing. It is an average sectoral PE ratio for companies in different sectors—I suppose that one can define them as being in a utilities sector—and in different types of businesses. There are different degrees of competition—some have no competition at all, others have competition in their own sector. For ~t example, there are, and always have been, two completely different classes of water company. To try to establish a single figure to make that calculation cannot be fair to all the companies that the Government are trying to tax.

Furthermore, we have seen the wide range of different industries in clause 2. Earlier, we discussed

whether the Bill was a de jure hybrid Bill—which it is clearly not—of a de facto hybrid Bill. The clause that announces all the different definitions of companies—which the Government have had to use to avoid making it a hybrid Bill—makes it clear to anyone reading it honestly that it is simply not possible fairly to produce a single PE ratio for all those companies that can be regarded as an adequate base on which to make the calculation.

I invite the Government to assess the matter impartially and to ask themselves whether they are treating the companies fairly and are seen to be doing so. Many of them work in central areas of the British economy; they are not only important in themselves, but provide important services to a wide range of other industries, on whose future the prosperity and jobs of millions of people in this country depend. It is vital that those companies believe that they are being treated fairly—visibly so—by the Government. I contend that the schedule is clearly inadequate in that it treats in them unfairly.

There are other important incoherencies in the schedule. Paragraph 6 makes clear that the initial period on which the calculations are based is arbitrary. The Paymaster General has explained that the four-year period which is used for the majority of the companies is related to the price cap that was put on them. But the game is given away by paragraph 6(2), which states:

> "Where the initial period of a company privatised by means of a flotation would ... include any time on or after I April 1997.

> sub-paragraph (I) shall not apply and the initial period of that company shall be taken, instead, to be the period which—(a) begins with the day on which the time of its flotation falls; and (b) ends with the end of the last financial year of the company to end before I April 1997."

No doubt that is administratively convenient, but it gives the game away that the four-year period, which can apply to all early privatisations, is not regarded as a central part of the calculation. The Government are prepared to introduce for any company which happened to have been privatised fewer than four years before I April 1997 an arbitrary cut-off date which may or may not give a realistic view of the company's long-term profitability, let alone its long-term capital needs. Those are two illustrations of the unfairness of the tax.

Reference has been made to the fact that Labour Members are rather cross that we are opposing the tax. Perhaps they feel that the Opposition should not have the right to oppose it. I simply point out that perfectly sensible, reputable, nonpolitical expert bodies have made the same points as Opposition Members. As I understand it, the Paymaster General has assured us that the proposed windfall tax will be creditable for United States tax purposes.

Mr. Geoffrey Robinson: I have not said that. I hate to say it, but the hon. Gentleman has been absent in mind—the matter is for the US tax authorities.

Mr. Green: That is an extremely interesting answer. I have listened carefully. I may have misunderstood,

but I got the impression that the Paymaster General held talks with the US tax authorities and, though perhaps not legally reassured, hoped that the windfall tax would be creditable for tax purposes in the United States. Is he now saying that that is not the case?

* * *

Mr. Geoffrey Robinson: First, it is important to deal with the issue of double taxation, which was raised in good faith by Opposition Members, although there was an element of scaremongering. Let me assure hon. Members that the measure is not in breach of any double taxation agreement. We have had discussions with American authorities and are satisfied on that point. Like them, we attach great importance to our double taxation agreements. We are an international trading country, dependent on those links and on our adherence to the standards established between ourselves and other countries.

It seems to me that there is a deliberate attempt to confuse companies with shareholders. We are taxing companies, not shareholders. Opposition Members may draw from that certain consequences—that is up to them—but the tax is imposed on the company, not on the shareholder.

Mr. Boswell: The Paymaster General will recall that my right hon. Friend and I spoke about the extent of those agreements, of which there are more than 100 affecting the United Kingdom. The hon. Gentleman referred to his discussions with American authorities. In fairness, that was the point raised by my hon. Friends because of the importance of

Britain's nexus of investments with the United States. However, bearing in mind that there are other and diverse agreements, will he give similar assurance that negotiations have been undertaken with other countries, both larger ones, such as Australia, Malaysia and Singapore, and some smaller nations?

Mr. Robinson: I am happy to assure the hon. Gentleman that the windfall tax does not breach existing double taxation agreements.

Mr. Gibb: The Paymaster General has missed the point. The reason why the Chartered Institute of Taxation is so concerned about the windfall tax breaching our array of double taxation agreements is that it taxes the capital gain made on the increase in value of a company. It is not a capital gain arising within a company, albeit that the Government are taxing the company. Because of the way in which schedule 1 is drafted, the windfall tax taxes the increase in value of the company during those four years. It is effectively a capital gains tax on a company's increase in value. The double tax treaties specifically state that a capital gain will be taxed, not in the jurisdiction in which the gain arises, but only in the jurisdiction in which the shareholder resides. Some shares in the utilities are owned in the United States and the windfall tax will tax the increase in value of the shares. It is clear in my view and, more importantly, that of the Chartered Institute of Taxation that the tax is in breach of the US-UK double taxation agreement.

Mr. Robinson: To be fair, the hon. Gentleman has made his points. He has threatened legal action,

which he will undertake personally, against the central authority of the British Government. He has threatened that the Institute of Chartered Accountants—that most conservative of all bodies—will launch itself against the legislative processes in the Bill. We tremble at the prospect, but we wish him well. Let litigation commence on the claim that we are in breach of any double taxation agreement. I do not believe that we are and I think that we can now pass to other matters.

Mr. Green: The Paymaster General makes a good joke, but I suggest that litigation may be instituted not by the Chartered Institute of Taxation or my hon. Friend, by litigious American shareholders and there are no more litigious people in the world. He may have been assured by one set of American lawyers or American Government lawyers that the B ill does not breach the agreement, but with all good intent I can only suggest that the smile will be on the other side of his face if he finds the British Government embroiled with angry Americans in a hugely expensive and long legal action in the American courts.

Mr. Robinson: I am grateful to the hon. Gentleman for that intervention and the admonition that came with it. He speaks with great authority; perhaps he was in the tobacco industry in a previous incarnation. We are satisfied that the provision is not in breach of double taxation agreements.

A valid point was made concerning the impact of the tax on profit and loss and where it would be accounted for on the balance sheet. We are happy to

discuss such matters with companies or their accountants.

The right hon. Member for Wells referred to extraordinary items which might be frequent. He is, as he admitted, a bit rusty on such matters. Extraordinary items are extremely rare, but exceptional items are more common. Perhaps he was referring to exceptional items. There is no other way of imposing the windfall tax if we want to be objective and sensible; it will be imposed at the bottom line after any extraordinary or, more likely, exceptional items.

Insofar as I could understand what the hon. Member for Bognar Regis and Littlehampton was saying about prior year adjustments, he must know as a distinguished member of his institution that prior year adjustments are hated by the profession. If any company is tempted by his comments or has any furtive thoughts of its own to try to get a prior year adjustment affecting the period in respect of which it will be taxed on windfall profits in the four-year period, we would resist that. No such prior year adjustment would be permitted in assessing the tax.

Mr. Gibb: I was not alluding to any tax avoidance. My point was that a genuine injustice may arise if a fundamental error occurred in the accounts and an adjustment was made in a subsequent year. That is not an infrequent occurrence in the accountancy profession. Such an adjustment could be quite large and there is no provision in the schedule to allow a just and reasonable adjustment to the windfall tax bill that the company would have received. It would

have been overtaxed merely because of an error in its earlier accounts. Such errors often occur—

The Chairman: Order. Will the hon. Gentleman intervene more briefly in future, which will probably be more effective?

Mr. Robinson: I take the point and stress again that we will not accept any such prior adjustments.

I turn now to the hon. Member for Cotswold, who had done his homework better than most, despite the alleged lack of time. He picked on the flotation price that we are attaching to the shares. He had not quite done all his homework as he did not push it to the logical conclusion. If, instead of the institutional price—the main price that affected most of the shares-owed had taken one of the lower prices for certain categories of shareholders to which the then Government thought it appropriate to give a discount, the benefit to the company would have been diminished. The benefit would be diminished; the gain would have been greater had the issue price been less. If he thinks through the logic of that he will see that taking the institutional price was the fairest and most decent thing that we could do for the company.

That brings me logically to the remarks made by the hon. Member for Ashford which were echoed by all Opposition Members. He raised the whole basis of the tax: the price earnings ratio, the period and the tax rate that we chose. While Opposition Members can continue to drone on about how arbitrary, unfair, pernicious, vindictive, injudicious and everything else

they think the tax is, there is one simple question: what would they want us to do?

Mr. Woodward: Nothing.

Mr. Robinson: That is why they were kicked out of office in so spectacular a fashion and why we now have this small enclave, represented so worthily here tonight from the south of England, and no representatives from the once great national party in Wales or Scotland. Those are the fruits of doing nothing. We gave a manifesto pledge. Do opposition Members suggest, if you will excuse a slight digression, Mrs. Winterton, that we should break all our promises, like they did? We promised to have a windfall tax. We said what we would do with it and we are now delivering our promise. That is why we were voted in and why the Government are wholly behind the proposed measures.

The price-earnings ratio is low; the tax rate is low. We could use the capital gains tax rates if the hon. Member for Ashford wanted that. We could use the price-earnings rate for each individual sector if he wanted that. We could come out with an average listing for utilities in the Financial Times, as was suggested in an earlier amendment, which would give Government windfall tax takings of £17 billion. Instead of that, we have taken a tax that is perceived by the market to be reasonable, is described in the newspapers as modest and which everyone, except the Opposition, has now accepted.

EXHIBIT 51-J

GROUP HISTORICAL COST PROFIT AND LOSS ACCOUNT

For the year ended 31 March 1992

Note		1992 £m	1991 £m
2	Turnover	847.1	779.4
	Cost of Sales	(571.4)	(536.3)
	Gross Profit	275.7	243.1
3	Operating costs	(187.7)	(172.8)
4&5	Operating Profit	88.0	70.3
7	Income from fixed asset Investments	9.8	8.8
	Profit on Ordinary activities before interest and taxation	97.8	79.1
8	Interest	(14.8)	(12.9)
	Profit on ordinary activities before taxation	83.0	66.2
10	Taxation on profit on ordinary activities	(20.7)	(15.0)
	Profit on ordinary activities after taxation	62.3	51.2

	Extraordinary Items—Privatisation costs	–	(3.6)
	Profit for the financial year	62.3	47.6
11	Dividend	(21.2)	(13.0)
22	Profit retained	41.1	34.6
12	Earnings per ordinary share:		
	Actual	50.6p	41.6p
	Pro forms	–	39.0p

* * *

EXHIBIT 52-J

SUMMARY GROUP HISTORICAL COST PROFIT AND LOSS ACCOUNT

For the year ended 31 March 1993

	1993 £m	1992 £m
Turnover	892.0	847.1
Operating Profit	102.5	88.0
Investment income	10.7	9.8
Net Interest	(12.1)	(14.8)
Profit on ordinary activities before taxation	101.1	83.0
Taxation	(23.4)	(20.7)
Profit on ordinary activities after taxation	77.7	62.3
Dividends paid and proposed	(24.5)	(21.2)
Retained Profit	53.2	41.1
Earnings per ordinary share	63.1p	50.6p
Dividends per ordinary share		
Interim	5.90p	5.25p
Final proposed	14.10p	12.15p
	£000	£000
Directors' emoluments (including performance related bonus)	941	1,170

EXHIBIT 53-J

SUMMARY GROUP HISTORICAL COST PROFIT AND LOSS ACCOUNT

For the year ended 31 March 1994

	1994 £m	1993 £m
Turnover	899.8	892.0
Operating costs	(701.0)	(789.5)
Operating profit	108.6	102.5
Income from interests in associated undertakings	0.9	0.1
Investment income	14.4	10.6
Profit before interest and tax	123.9	113.2
Interest	(7.1)	(12.1)
Profit on ordinary activities before tax	118.8	101.1
Tax	(23.9)	(23.4)
Profit for the financial year	92.9	77.7
Dividends paid and proposed	(28.9)	(24.5)
Retained profit for the year	64.0	53.2
Earnings per ordinary share:	75.4	63.1p
Dividends per ordinary share:		
Interim	7.0p	5.9p
Final Proposed	16.5p	14.1p

	23.5p	20.0p
	£000	£000
Directors emoluments (including performance related bonus)	866	855
Pension contributions relating to Directors	202	86
There were no recognizes gains or losses other than the profit for the period		

SUMMARY GROUP HISTORICAL COST BALANCE SHEET

At 31 March 1994

	1994 £m	1993 £m
Tangible assets	509.6	475.9
Investments	68.9	68.3
Fixed assets	578.5	544.2
Current assets	301.0	213.2
Creditors: amounts falling due within one year	(204.5)	(175.8)
Net current assets	96.5	37.4
Total assets less current liabilities	675.0	581.6

Creditors: amounts falling due after more than one year	(92.3)	(86.7)
Provisions for liabilities and changes	(39.7)	(16.0)
Minority interests	(0.1)	(0.1)
Net assets	542.9	478.8
Capital reserves:		
Called up share capital	61.6	61.6
Share premium account	0.3	0.2
Revaluation reserve	49.1	49.1
Profit and loss account	431.9	367.9
Shareholders' funds	542.9	478.8

EXHIBIT 54-J

SUMMARY GROUP HISTORICAL COST PROFIT AND LOSS ACCOUNT

For the year ended 31 March 1995

There are no recognizes gains or losses other than the profit for the year, and accordingly a statement of recognized gains and losses is not presented

	£Cap	1995 £m		1994 £m	
Turnover	3				
Continuing operations		797.8		827.0	
Discounted operations		77.1		72.6	
		874.9		899.6	
Operating costs	4	(755.4)		(791.0)	
Operating profit	3				
Continuing operations		118.2		105.5	
Discounted operations		1.3		2.1	
			119.5		108.6

Exceptional item—discontinued operations	3	(20.0)	–
Income from interest in associated undertakings		1.2	0.9
Income from fixed asset investments	3	15.3	14.4
Profit on ordinary activities before interest and tax		118.0	123.9
Interest	5	(4.5)	(7.1)
Profit on ordinary activities before tax		111.5	116.8
Tax on profit on ordinary activities	6	(25.6)	(23.9)
Profit for the financial year		85.9	92.9
Dividend	7	(32.2)	(28.9)
Retained Profit for the year	21	53.7	64.0

Earnings per ordinary share:	8		
Before non-operating exceptionalism		83.7p	75.4p
Base		72.4p	75.4p

EXHIBIT 68-P

FINANCIAL REPORTING REVIEW PANEL'S REPORT RELATING TO SWEB

OCTOBER 15, 1998

Gale Klappa Esq
Chief Executive and Chairman
SWEB
800 Park Avenue
AztecWesl
Almondsbury
Bristol
BS324SE

Dear Gale Kappa

I am writing in response to the recent letters received from Mr Oosthuizen (dated 30 September and 12 October respectively) in respect of the matter of the company's revised 1995 and 1996 accounts which the Panel has had under review.

The panel has now had the opportunity of carefully considering the correspondence and explanations put to it by both yourself and your auditors in respect of the items first brought to the Panel's attention in April this year. I am writing to you now to let you know that we will not be pursuing the enquiry further.

As you know, the matter of the revised accounts was brought to the attention of the Panel by the Inland Revenue who contended that the original 1995 and 1996 accounts presented a true and fair view of the results and the financial position of the company in

respect of those two periods and that the revised accounts simply presented an. alternative view of what Was true and fair. It was suggested that the revised accounts should be withdrawn on the basis that the original accounts were not defective and therefore the revised accounts invalid.

Having considered the information made available to it through correspondence and at a meeting on 29 June the Panel is of the view that the company was justified in revising the 1995 and 1996 accounts on the basis that the company found that the provision set up in prior years accounts had been inadequate, based on a report prepared in May 1994. The Panel accepts that this discovery established that a fundamental error had been made in the original accounts and that the company was justified in revising those accounts to reflect the additional costs that would be incurred in meeting the liability then in existence.

I am aware that we have received conflicting advice on the matter of whether or not the Panel has the authority to enquire into the Original 1995 and 1996 accounts. As the Panel has concluded to the company's satisfaction in the matter of the particular accounts under review, I do not consider that this Issue should be pursued in the context of the revised accounts of your company. As the principle at issue is one that affects or could affect other companies who similarly revise their accounts, you will appreciate that the Panel will, at its own leisure, clarify the matter of its authority to enquire into the appropriateness of the decision to prepare revised

accounts. I will not therefore comment further on the note of conference with Robin Potts QC at this stage.

On behalf of the Panel and particularly Matthew Patient, my Deputy Chairman, I would like to thank you and your colleagues for the way in which you have conducted this enquiry and the speed and efficiency with which you have responded to the Panel's particular enquiries. I confirm that this correspondence marks the end of the Panel's enquiry into the company's revised 1995 and 1996 accounts. As part of our routine process, we will be writing to the Inland Revenue informing them, as the complainant, of our decision.

/s/
PETER GOLDSMITH QC
Panel Chairman

EXHIBIT 117-J
WINDFALL TAX STATUTES

Parts of Treas. Reg. § 1.901-2 Not in Dispute

Treas. Reg. § 1.901-2(a)(1)(i)

Treas. Reg. § 1.901-2(a)(2)

Treas. Reg. § 1.901-2(a)(3)(ii)

Treas. Reg. § 1.901-2(c) in its entirety

Treas. Reg. § 1.901-2(d) in its entirety

Treas. Reg. § 1.901-2(e) in its entirety

Treas. Reg. § 1.901-2(f) in its entirety

Treas. Reg. § 1.901-2(g) in its entirety

Parts of Treas. Reg. § 901-2 Not Relied Upon By Petitioners

Treas. Reg. § 1.901-2(b)(2)(i)(B)

Treas. Reg. § 1.901-2(b)(2)(i)(C)(1)

Treas. Reg. § 1.901-2(b)(2)(i)(C)(2)

Treas. Reg. § 1.901-2(b)(2)(ii)

Treas. Reg. § 1.901-2(b)(2)(iii)

Treas. Reg. § 1.901-2(b)(3)(i)(B)

Treas. Reg. § 1.901-2(b)(4)(i)(B)

Parts of Treas. Reg. § 1.901-2 At Issue

Treas. Reg. § 1.901-2(a)(1) to the extent not mentioned above

Treas. Reg. § 1.901-2(a)(3)

Treas. Reg. § 1.901-2(b) to the extent not mentioned above

EXHIBIT 118-R

Exhibit 118-TR

U.K. Windfall Tax Calculations for the 12 U.K. Regional Electricity Companies - £ Millions (IP = Initial Period)

							days = 5 ÷1461			
							days x 365	7 =		
							days x 9=	# Shares x		
						5=1+2	Company	£2.40/share =		
		1	2	3	4	+3+4=	Value in	Value Placed	8= 6-7=	
		Profit	Profit	Profit	Profit	Total 4 Yr.	Profit Making	on Company	Taxable	9 = 8 x 23%
No.	Company Name	IP Yr.1	IP Yr.2	IP Yr.3	IP Yr.4	IP Profits	Terms	at Flotation	Amount	Windfall Tax
1	East Midland Electricity plc	£ 109.3	£ 116.6	£ 27.7	£ 164.7	£ 418.0	£ 939.9	£ 523.3	£ 416.5	£ 96.5
2	London Electricity plc	£ 103.5	£ 108.0	£ 142.0	£ 149.9	£ 503.4	£ 1,131.9	£ 523.3	£ 608.5	£ 140.0
3	Manweb plc	£ 69.8	£ 82.3	£ 99.3	£ 62.8	£ 314.2	£ 706.5	£ 285.6	£ 420.9	£ 96.8
4	Midlands Electricity plc	£ 102.7	£ 116.9	£ 137.2	£ 126.2	£ 483.0	£ 1,086.0	£ 502.6	£ 583.4	£ 134.2
5	Northern Electric plc	£ 73.3	£ 85.3	£ 98.3	£ 103.2	£ 360.1	£ 809.7	£ 295.4	£ 514.3	£ 118.3
6	NORWEB plc	£ 88.1	£ 111.5	£ 131.2	£ 153.6	£ 484.4	£ 1,089.2	£ 414.5	£ 674.6	£ 155.2
7	SEEBOARD plc	£ 68.2	£ 79.0	£ 96.5	£ 103.9	£ 347.6	£ 781.6	£ 305.7	£ 475.9	£ 109.4
8	South Wales Electricity plc	£ 51.4	£ 60.9	£ 74.9	£ 94.8	£ 282.0	£ 634.1	£ 243.5	£ 390.5	£ 89.8
9	South Western Electricity plc	£ 62.3	£ 77.7	£ 92.9	£ 73.5	£ 306.2	£ 688.5	£ 295.4	£ 393.1	£ 90.4
10	Southern Electric plc	£ 129.0	£ 147.2	£ 173.4	£ 155.5	£ 605.1	£ 1,360.5	£ 647.7	£ 712.8	£ 164.0
11	Yorkshire Electricity Group plc	£ 100.2	£ 111.3	£ 106.9	£ 160.9	£ 479.3	£ 1,077.7	£ 497.4	£ 580.3	£ 133.5
12	Eastern Electricity plc	£ 104.3	£ 135.2	£ 123.3	£ 141.1	£ 503.9	£ 1,133.0	£ 647.8	£ 485.2	£ 111.6

EXHIBIT 138-P

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Report of Professor Stephen C. Littlechild
On Behalf of PPL Corporation and Subsidiaries

September 8, 2008

[Table of Contents omitted in printing this appendix]

THE BACKGROUND TO THE UK WINDFALL PROFITS TAX

A. Introduction

I have been asked by counsel for PPL Corporation to set out the background to the imposition and implementation of the Windfall Profits Tax in the U.K. I have also been asked to offer my opinions

regarding how the companies subject to that tax earned excessive profits in the period following their privatisation and leading up to the enactment of the Windfall Tax and the role that those excessive profits may have played in the enactment of the Windfall Tax.

My report traces the political and regulatory history of privatised companies in the U.K. from the election of Mrs. Thatcher's Conservative Government in 1979 and the privatisation of the utility companies in the 1980' s and 1990' s through the election of Mr. Blair's Labour Government in May 1997 and the enactment of the Windfall Tax in July 1997. It covers the general principles of regulating the privatized utility companies; the implementation of the "RPI-X" regulatory regime for utilities that I proposed in 1983, and which was applied to the utilities that were subject to the Windfall Tax; the manner in which those companies were able to earn profits under that regime that were perceived as excessive; and a participant's view of the political and regulatory environment in the U.K. immediately preceding the enactment of the Windfall Tax.

I am uniquely situated to offer an opinion on these matters in view of my experience as the regulator of many of the companies subject to the Windfall Tax and my corresponding responsibility to advise the relevant Minister (Mr. Geoffrey Robinson) on the impact of the Windfall Tax on the electricity companies.

B. Overview

1. I have been asked to set out the background to the imposition and implementation of the Windfall Profits Tax in the UK. This account will include the following:

   - the economic problems in the UK preceding the election of the Conservative Government under Mrs. Thatcher in 1979 and the program of privatisation that this Government implemented
   - the design of a new approach to regulation known as RPI-X or incentive price-cap regulation, that stood in contrast to traditional rate of return regulation in the US
   - the application of that method to all the privatised utilities
   - a description of the regulatory framework for the electricity distribution companies
   - the concept of encouraging efficiency and sharing its benefits
   - the initial experiences of the privatised utilities in terms of increased efficiency and increased profits
   - the growing concerns about these excessive profits, and
   - the proposal by the Labour party while in opposition for the imposition of a Windfall Tax on these excessive profits, the implementation of that tax when the

Labour party was elected to office in 1997, and the underlying rationale for that tax.

2. I have been asked to present this account from my own perspective as someone who participated actively in the design and implementation of UK privatisation and regulation policy, not least as the first regulator of the privatised electricity industry (Director General of Electricity Supply) from 1989 to 1998. One of my responsibilities was to advise the relevant Minister (Mr. Geoffrey Robinson) on the impact of the Windfall Tax on the electricity companies. The electricity companies that I regulated comprised 17 of the 32 Windfall Tax companies. I also bring to this issue the experience of having lived in the USA and studied utility regulation there for a period of nearly five years in the late 1960s, with frequent visits thereafter.

3. In order to explain this perspective, I begin with a relatively extensive statement of my experience and Qualifications to provide this evidence. I then describe in turn the developments summarised in the first paragraph above.

4. I am being compensated in this matter at the rate of £375 per hour. As of September 8, 2008, I have invoiced £51,072.95 (which includes £6,916.70 in expenses) to PPL Corporation for my services.

C. Qualifications

5. My academic qualifications are primarily in the economics of regulated utilities. In 1964, I was awarded a Bachelor of Commerce degree at the University of Birmingham in England. For the following year I was Temporary Industrial Lecturer in Industrial Economics there, during which time I studied and lectured on the pricing and investment policies of regulated and nationalised (that is, publicly owned) industries. I then came to the US for graduate study in Operations Research at Stanford University. After two years I moved to Northwestern University to work with a particular professor, who later moved to the University of Texas at Austin. I moved with him to finish my Ph. D. there in 1969. During this period I applied ideas from operations research to the pricing and investment policies of Illinois Bell Telephone Company. On the basis of this research, I was awarded an AT&T Postdoctoral Fellowship in Public Utility Economics, which I held at UCLA and Northwestern Universities. This enabled me to extend my understanding of US public utilities and their regulation.

6. From 1970 to 1975, I was Senior Research Lecturer and then Professor of Applied Economics at the University of Aston Management Centre in England. There, I continued to develop my expertise in telecommunications economics, and I published one of the first textbooks on that topic. I continued to keep in close touch with regulatory

developments in the US, including as Visiting Scholar in the Economics Department at UCLA in summer 1975. Later in 1975, I was appointed as Professor of Commerce and Head of the Department of Industrial Economics and Business Studies at the University of Birmingham, in which positions I served for 14 years. In 1979/80, I was a Visiting Professor or Research Fellow at New York University, Stanford University, the University of Chicago, and Virginia Polytechnic and Institute. During several years of the 1970s, I was also a part-time Economic Adviser in the Treasury in London, particularly concerned with policy towards the nationalised industries.

7. During the late 1970s, I became increasingly interested in the workings of competitive markets, and the scope for improvement in regulated and nationalised industries. From my studies and experience in the US, I was aware of the research of economists explaining the inefficiencies associated with regulation and public ownership. I argued that whereas economic theory had hitherto focused primarily on getting prices to reflect costs, in practice it was more important to ensure that costs were at an efficient level. This led me to see the need to improve the incentives on nationalised industries. This could be done by opening these industries to competition, by sharpening financial disciplines, and, most importantly, by transferring them from public to private ownership.

8. Starting in 1979, the new Conservative Government began to adopt policies that emphasised competition, financial disciplines and privatisation. In 1982, the Government decided to privatise British Telecommunications (BT). There was a difference of view as to what method of regulation to use. In view of my experience in telecommunications economics, utility regulation, privatisation, and competition issues, the Secretary of State asked for my advice on how to regulate BT. I reported in February 1983.[1] I recommended that regulation should not be based on US rate of return control, but instead should use an incentive price cap that became known as RPI-X. This is discussed below.

9. This method was adopted and proved satisfactory, and it was adopted for all the subsequent utility privatisations. In various ways I advised on regulation for many of these utility privatisations, including gas, water and rail. I was a part-time Member of the Monopolies and Mergers Commission over the period 1983-89. In that capacity, I participated in the decision on how to regulate Manchester Airport and in another decision on the regulation of British Gas.

10. In autumn 1987 the Conservative Government under Mrs. Thatcher was elected for a third term of office. The manifesto included a

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[1] S C Littlechild, *Regulation of British Telecommunications' Profitability*, London, Department of Industry, 1983.

commitment to privatise the electricity industry. In view of my extensive experience in regulation and privatisation, the Secretary of State for Energy invited me to advise him on the regulatory issues involved in electricity privatisation. Amongst other things, I advised on the White Paper in February 1988 that proposed the broad framework of privatisation, competition, industry restructuring, and regulation for the electricity sector.[2] Over the next year or so I continued to advise on legislation, license conditions, and other aspects of the implementation of this policy.

11. The Electricity Act of July 1989 provided for the privatisation and regulation of the industry. It created the post of Director General of Electricity Supply to regulate the privatised electricity industry in England, Wales and Scotland. Among the electricity companies regulated were 17 of the 32 companies subsequently liable for the Windfall Tax.[3]

12. The Secretaries of State for Energy and for Scotland appointed me to be the first such Director General for a period of five years as from 1 September 1989. In 1994 that appointment was subsequently renewed for a further five years.

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[2] Privatising Electricity, White Paper, Department of Energy, London, February 1988.

[3] These companies were the 12 Regional Electricity Companies, two Scottish electricity companies (Scottish Power and Scottish Hydro-Electric) and three generating companies (National Power, PowerGen and British Energy).

13. At the time of privatisation the Government set price controls on the newly privatised electricity distribution companies to cover the five-year period from April 1990 to March 1995. During my term of office, among many other things I enforced those price controls. In due course I reset those controls to cover the period April 1995 to March 2000. I had direct experience of dealing with complaints about excess profits of the electricity companies. I was in office in 1992 when the Labour Party first proposed a Windfall Tax, and in May 1997, when the Labour Government was elected on a manifesto that included the Windfall Tax. Along with other utility regulators, I was asked by the Government to advise on the impact of the Windfall Tax on the companies to which it applied that were in my sector of responsibility. Later sections of my Report set out this experience in more detail.

14. In June 1997 the Labour Government reviewed utility regulation and decided to amalgamate the regulatory offices for gas (OFGAS) and electricity (OFFER) to form a single Office of Gas and Electricity Markets Regulation (OFGEM). I stepped down from my position as Director General of Electricity Supply on 31 December 1998.

15. Since that time I have been a Principle Research Fellow, later Senior Research Associate, at what is now the Judge Business School at the University of Cambridge. I am an Emeritus Professor at the University of Birmingham. I am

also an international consultant on privatisation, competition, and regulation. In this capacity, I have consulted for many governments, international agencies, regulatory bodies, and regulated companies in the UK, US, and in some twenty overseas countries. In addition, I am presently a Commissioner at the UK Postal Services Commission (Postcomm), and a member of the Airports Price Control Advisory Group of the UK Civil Aviation Authority (CAA).

D. UK Economic Problems and Privatisation

16. During the 1970s, the UK economy was experiencing increasing difficulties. Many of the key industrial sectors appeared to be inefficient and uneconomic. Several of the large state owned companies were incurring losses. The industrial sector as a whole was becoming more uncompetitive on world markets. Wages, costs and prices were increasing and appeared to be out of control. The Labour Government attempted to impose limits on pay rises. Trade unions frequently called strikes in the public and private sectors. They appeared to have excessive power. At one point, a three-day week was in effect. There were electricity power cuts. Strikes by refuse collectors left rubbish rotting in the streets. Picketing by National Health Service workers meant that many hospitals were limited to taking emergency patients only. Strikes by gravediggers left bodies unburied. The winter of 1978179 was known as the Winter of Discontent. The Conservative Party, led by

Mrs. Thatcher, contested and won the 1979 election under the slogan "Britain isn't working."

17. A central aim of the new Conservative Government was to rebuild Britain's economy. At the macroeconomic level that meant following a policy of balancing the budget and controlling the money supply (monetarism) in order to combat inflation. At the microeconomic level it meant taking steps to increase efficiency among all enterprises, both state-owned and privately-owned. Increasingly, it meant privatising loss-making state-owned enterprises to enable them to operate more efficiently without government control, and encouraging competition where that had previously been absent.

18. Initially, attention focused on the manufacturing companies that had been taken into state ownership, often as so-called "lame ducks" during the 1960s and 1970s. These were companies employing large workforces that had become uncompetitive and unprofitable. If they had not been taken over by the state they would have gone bankrupt, making large numbers of workers unemployed. But once having been taken over, they had little incentive to improve performance and cut costs. Their efficiency did not increase significantly, and they continued to be a drain on the country's resources.

19. The need for change, and the severity of the new Government's policy, are indicated by the reductions in the workforces in the state-owned

manufacturing companies such as British Shipbuilders, Rolls Royce, British Leyland Cars, and British Steel. Over just two years, 1979/80 to 1981182, the reductions ranged from 16% to 38%.[4]

20. In contrast, reductions were relatively small in the nationalised utility industries such as electricity, rail, and airports. Over the same period, workforce reductions ranged from 8% down to 3%. At British Gas there was no change in the workforce, and there was an increase of 2% at British Telecommunications. The contrast with the manufacturing industries suggests the potential scope for efficiency improvements that subsequently occurred after privatisation of the utilities, although this was not widely appreciated at the time.

21. Over the period 1981 to about 1987 the state-owned manufacturing companies were gradually privatised. That is, they were sold either via flotation (Initial Public Offerings or IPOs) on the stock market or in trade sales to individual private buyers.

22. The Government also turned its attention to the nationalised utility industries. Many of their products were basic inputs into the whole of the manufacturing sector, and it was important that they be operated as efficiently as possible. There

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[4] Source: Michael Beesley and Stephen Littlechild, "Privatization: Principles, Problems and Priorities," Lloyds Bank Review, 149, July 1983, p. 10.

were, however, additional considerations to bear in mind with such industries.

23. In many respects these were monopolies, either by statute or de facto. It was unclear whether competition could or would develop. There was a need to consider how best to protect customers. In some cases these industries were regarded as providing products that were "public" goods rather than "private" goods, or products that should be provided on the basis of need rather than ability to pay.

24. There was also another set of concerns. Private shareholders might be wary of investing in the privatised utility companies because of the public interest in their prices and the history of government interference. Also, the size of these companies raised a question whether the capital markets could cope with them.[5]

25. British Telecommunications (BT) was in fact the first utility to be considered for privatisation. I discuss in the next section the regulatory issues that it raised and how the RPI-X price cap incentive scheme was developed to deal with these issues. After that, the RPI-X incentive scheme was used to enable privatisation of most of the other utilities over the next ten years or so. In chronological order, these utility privatisations were: British Telecommunications

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[5] For example, the privatisation of 51 % of British Telecommunications for £3.9 billion was at the time the largest equity offering ever made anywhere in the world. It was approximately equal to the total capital typically raised on the London Stock Exchange in a whole year.

in 1984, British Gas in 1986, British Airports Authority in 1987, the ten Water companies in 1989, twelve Electricity distribution companies in 1990, two Electricity generation companies, and two Scottish electricity companies in 1991, Northern Ireland Electricity in 1993, Railtrack in 1996, and British Energy (comprising the nuclear generating stations) also in 1996. These privatisations correspond to the 32 companies on which the Windfall Tax was subsequently levied.

E. Incentive Regulation: The Invention of RPI-X

26. Once the Government had decided to privatise BT, the questions arose as to whether it was necessary to regulate it and, if so, what type of regulation would be appropriate. After consideration, the Government decided that, unlike the previously privatised manufacturing companies, it would be unacceptable simply to leave BT subject to competition legislation as implemented by the Office of Fair Trading. BT was a large and dominant company in its sector, at least initially, and social and political considerations were involved. The Government decided that there was an ongoing need for company specific regulation, and that this was best carried out by a new regulatory body, the Office of Telecommunications Regulation (Oftel).

27. The next question was whether some kind of regulation of BT's profits or rate of return should be put in place before privatisation. Officials at the Department of Industry (BT's sponsor department) proposed a maximum rate

of return for the company's profitability. This would be calculated in a similar way to the allowed rate of return in US utility regulation. As a maximum rate, it would be set higher than such an allowed rate of return might otherwise be set. However, once BT reached that level of return, it would be obliged to return some or all of any excess profits to its customers.

28. Professor Walters, economic adviser to the Prime Minister Mrs. Thatcher, opposed such a scheme. He said it had many of the characteristics of a 100 per cent tax rate. It would have undesirable consequences for cost control and enterprise. Research on rate of return regulation in the USA had shown that it resulted in waste of investment and a costly bureaucracy.

29. In the absence of agreement on this matter, the Secretary of State asked me to study alternative schemes to regulate BT's profitability. The study was to have regard to the statutory objectives on the Secretary of State and Oftel, and to various other considerations.[6]

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[6] The statutory objectives included: to satisfy all reasonable demands for telecommunications services, for the investors to achieve a sufficient return on capital to finance the supply of services, to promote the interests of customers, and to maintain and promote effective competition. In addition, the study was to have regard to preventing the use of a dominant market position to exploit consumers, encouraging efficient telecommunications systems, ensuring the maximization of net proceeds from the sale (on particular regulatory and profit assumptions), and facilitating the successful operation of BT plc as a commercial organisation after flotation. This list indicates

30. My report was published in February 1983.[7] In appraising alternative schemes, and the role of regulation generally, I was strongly aware of what economists had found about how US utility regulation worked and what experience there had shown. For example, I wrote "Competition is by far the most effective means of protection against monopoly .... US experience in airlines and telecommunications shows how overzealous regulation has restricted competition, to the detriment of customers." I therefore proposed that steps should be taken to encourage competition so as to reduce the need for regulation.

31. Nevertheless, I considered that some regulation would be needed until competition developed. I concluded that the maximum rate of return scheme would introduce disincentives to efficiency and innovation. I then proposed a new scheme to limit local telephone call prices using the RPI-X formula.[8] In my view, this scored highly on all the criteria specified by the Secretary of State.

32. The idea behind my proposed scheme was that allowing telephone prices to rise at the annual rate of inflation (measured by the Retail Price Index or RPI) for a specified period of years would protect investors against the risk of

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the multitude of considerations that had to be balanced in determining a scheme of regulation.

[7] Littlechild Report (fn I para 8 above).

[8] Littlechild Report (fn 1 para 8 above), para 1.5c.

inflation (which at that time—in the early 1980s —was a serious risk). The X factor, to be specified by the Secretary of State at the time of privatisation, would require telephone prices to fall by X per cent a year in real terms, which would provide tangible protection for customers. Moreover this approach would provide better incentive to efficiency than a rate of return approach. This is because it would allow the company to keep the results of any reductions in costs and increases in efficiency during the specified period of the control, which would be several years. In this way, the gains from prospective increases in efficiency could be maximised and shared between investors and customers.

33. In short, the emphasis was on increasing efficiency, unlike the emphasis in US utility regulation. To that end, the control was on prices, and not on profits or rate of return as in US utility regulation. In particular, the regulator would be expected not to intervene until the end of the specified price control period, regardless of the profits that were being made. High profits would be a sign of increased efficiency, which was to be encouraged. It was assumed that the level of the X factor would be set so as to ensure that customers were sufficiently protected during this period, and able to share in the prospective increase in efficiency.

34. My report recommended that, at the end of the specified period, the regulator should review

experience and consider whether to continue the RPI-X incentive scheme. The regulator should then consider what level of X would now be appropriate, or alternatively what if any other control should be put in place.

35. The Secretary of State accepted this RPI-X incentive scheme. There was some discussion over the level of X, what set of telephone calls it should cover, and the duration of the control. The Government decided to set a level of X=3% on the average UK telephone call price, for a period of three years. That is, the RPI-3 price control meant that BT had to reduce the average UK telephone call price by 3% a year in real terms, for each of the next three years. Subject to that constraint, there was no limit on the profit or rate of return that BT could earn.

F. Privatisation and Regulation of the Other Utilities

36. BT was privatised with this price control in 1984. A similar RPI-X approach was used to privatise British Gas in 1986 and British Airports Authority in 1987. These companies operated in markets that were not then fully competitive, but could be expected to become more competitive in due course.

37. The proposed privatisation of the Water companies posed a new question: What if competition could not be expected to develop in the foreseeable future? Could the RPI-X method be used on a permanent basis?

38. The Government asked me to consider this question. I concluded that the RPI-X method could indeed be used on this basis, but it was necessary to supplement it by setting minimum quality standards. In the case of telecommunications it had been assumed that competition would provide the necessary incentive to maintain and improve quality of service. In the case of water, such competition could not be assumed. The Government accepted this advice and privatised the water companies with RPI-X price controls together with specified minimum standards of service on water quality.

39. In 1987, the Government decided to privatise the electricity industry. This raised another key question: how far was it possible to create viable competition in this sector, where none had existed previously? This was a particularly important question because there had begun to be criticisms that the privatisations of BT and British Gas had led to increased efficiency and increased profit for shareholders, but not to increased competition or to corresponding benefits to customers.

40. As explained above, the Secretary of State for Energy invited me to advise him on this privatisation. In the light of advice from myself and others, the Government decided to restructure the electricity industry.[9] Regulation

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[9] The restructuring separated the activities of generation and transmission, split the generation business into three separate generation companies, and enabled all generating companies to use the transmission network on nondiscriminatory terms. This

of the transmission and distribution network monopolies would still be required, and should encourage improved efficiency. For this purpose, RPI-X price controls would again be appropriate.

41. The Electricity Act of July 1989 made provision for restructuring and privatising the industry, and for creating a Director General of Electricity Supply to regulate the industry via a set of licences for the companies involved. I was appointed as Director General as from 1 September 1989. I set up the Office of Electricity Regulation (OFFER) and proceeded to appoint staff. OFFER was responsible for regulating all the companies in the electricity sector, with respect to matters such as price, quality of service, competition, and consumer affairs.

42. The separation of the electricity industry into different companies, and the operation of the licenses including the price controls, came into effect on Vesting Day, 31 March 1990. The twelve Regional Electricity Companies (RECs) were floated on the Stock Exchange in December 1990. The two fossil fuel generating companies (National Power and PowerGen) and the two Scottish electricity companies (Scottish Power and Scottish Hydro-Electric) followed in, respectively, March and June 1991. Northern Ireland Electricity was privatised in 1993.

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created initial competition in generation and facilitated the entry of new generators. In addition, generators and other electricity supply companies were given non-discriminatory access to the distribution network wires so they could compete to supply final users of electricity.

British Energy (comprising the nuclear generating stations) was privatised in 1996.[10] The next section discusses in more detail the privatisation and regulation of the electricity companies.

43. Rail was the final utility sector to be privatised. It was a controversial privatisation, partly because of the sensitive nature of the industry, partly because by now there was increasing public resistance to privatisation, and partly because the industry was extensively restructured before or at the time of privatisation. Nevertheless the concept of RPI-X controls was reflected in key aspects of the contracts involving the track network Railtrack, again with the emphasis on encouraging improvements in efficiency. Railtrack was privatised in 1996.

44. After each utility privatisation (or group of privatisations), the National Audit Office (NAO) issued a report by the Comptroller and Auditor General into how far the Government achieved the objectives that it set for itself with respect to the sale in question.[11] In general, the reports

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[10] The National Grid Company (NGC) was not privatised by flotation, but rather as a jointly-owned subsidiary of the 12 RECs.

[11] National Audit Office, Report by the Comptroller and Auditor General: *Department of Trade and Industry: Sale of Government Shareholdings in British Telecommunications plc* (9 July 1985); National Audit Office, Report by the Comptroller and Auditor General: *Department of Transport: Sale of Government Shareholdings in BAA plc* (8 February 1988); National Audit

conclude that the Government achieved its objectives, which included maximising the proceeds of flotation. The Reports do not suggest that the Government sold those companies too cheaply.

G. Privatisation and Regulation of the Electricity Industry

45. A general principle in setting UK price controls, for utilities generally and for the electricity sector in particular, was to distinguish between competitive and non-competitive activities. Essentially all the companies would be licensed and regulated but not all would have price controls. Those activities that were expected to be competitive, such as generation, would have

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Office, Report by the Comptroller and Auditor General: *Department of Energy: Sale of Government Shareholdings in British Gas plc* (30 June 1987); Northern Ireland Audit Office, Report by the Comptroller and Auditor General of Northern Ireland: *The Privatisation of Northern Ireland Electricity* (26 October 1994); National Audit Office, Report by the Comptroller and Auditor General: *Department of the Environment: Sale of the Water Authorities in England and Wales* (14 February 1992); National Audit Office, Report by the Comptroller and Auditor General: *The Sale of the Twelve Regional Electricity Companies* (6 May 1992); National Audit Office, Report by the Comptroller and Auditor General: *The Sale of National Power and PowerGen* (4 June 1992); National Audit Office, Report by the Comptroller and Auditor General: *The Sale of ScottishPower and Hydro-Electric* (10 July 1992); National Audit Office, Report by the Comptroller and Auditor General: *Department of the Environment, Transport and the Regions: The Flotation of Railtrack* (10 December 1998); National Audit Office, Report by the Comptroller and Auditor General: *Department of Trade and Industry: The Sale of British Energy* (6 May 1998).

no controls on prices or profits. Those activities that were not expected to be competitive, namely transmission and distribution networks, would have RPI-X incentive price controls. Those activities where competition was envisaged but was not yet allowed or not yet effective, as in retail supply to final customers, would have transitional price controls.

46. The electricity sector may be considered as comprising four main activities in a vertical supply chain: generation, transmission, distribution and retail supply, together with some other associated activities. At the time of privatisation the regional electricity companies (RECs) had a mix of activities, some of which were subject to RPI-X regulation and some of which were not.

47. The RECs had two main activities. One was owning and operating the distribution network in its local area. This business was subject to an RPI-X price control. It was the major source of profit for the RECs.

48. The other main activity of a REC was the supply of electricity. This involved the purchase of electricity from generating companies and its subsequent resale to end-user customers within its local area. It too was subject to an RPI-X price control. The supply business was not a major source of profit for the RECS.[12]

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[12] Over a period of eight years, this market was opened to competition, so that generators and other suppliers could compete to supply the same customers. The RECs were subject

49. The RECs could compete to supply electricity in other areas. Some did, others did not. Again, this business was low margin and not a major source of profit.[13]

50. Thus, the Government decided to set two RPI-X price controls on each REC at the time of privatisation: one on its distribution business, and another on its supply business. The value of X in the distribution business control was called Xd, and the value of X in the supply business was called Xs. I concentrate in this report on Xd in the price control of the distribution business

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to a transitional RPI-X price control on sales within their area. However, the costs of generation and of using the distribution system, which accounted for most of the supply business costs, were simply passed through to customers. The RPI-X control effectively applied only to a small amount of other costs (such as billing and collection), and allowed the RECs only a low margin on these costs.

[13] As regards their other activities: a) RECs typically had no involvement in generation at the time of privatisation. To varying degrees most RECs became more involved in that activity over time. There was no price control on generation but it was a more risky business and it took time for any profits to emerge. b) For an initial period of years the RECs were joint owners of the National Grid Company (NGC), which itself was subject to an RPI-X price control, and they received dividends from NGC. They disposed of this ownership stake in 1995 and returned a substantial part of the proceeds to customers. c) Each REC had a set of retail outlets selling electrical appliances, and an electrical contracting business (installing, repairing and maintaining electrical wiring and equipment in customer premises). These businesses were not subject to price controls, and accounted for a relatively small proportion of total profits. Indeed, there was some doubt whether appliance retailing was even profitable for the RECs.

because that was the main source of the profits of the RECs.

51. Before Vesting (March 1990), the Secretary of State set the RPI-X controls for the 12 regional electricity distribution companies. I was not party to the thinking, discussions and decisions on the levels of these controls. Although as regulator it would be my duty to monitor, enforce and, where necessary, modify these price controls, in my view it was preferable that responsibility for setting the initial controls should lie clearly with the Government.

52. The Secretary of State for Energy took advice from technical consultants on the appropriate future investment programmes of the RECs, and from merchant bankers on the financial capital structure and profit projections that would be needed to float the companies successfully. The Secretary of State said in Parliament that there was a need for a significant increase in capital expenditure on the distribution networks in order to replace investments made some 40 years earlier and now said to be corning to the end of their physical lives. According to the Prospectus:

> "The initial values of Xd differ between the RECs and were set by the Secretary of State having regard to projections of certain parameters for each REC's businesses, including estimates of growth

in units distributed, scope for cost control and capital expenditure."[14]

53. On this basis, the Government set controls for RECs of the form RPI+X rather than RPI-X. That is, it provided for annual real increases in distribution charges, above the rate of inflation, rather than real reductions in these charges. This suggests that the Government was very conscious of the cost of the additional capital expenditure, and not confident that this additional cost would be outweighed by any scope for reductions in operating costs as a result of increased efficiency.

54. Table 1 sets out the values of X that the Government set for each of the 12 RECs in England and Wales. The X factors ranged from 0 to 2.5. For example, SWEB was allowed to increase its distribution business prices by 2.25% per year plus whatever the rate of inflation turned out to be.

55. The lower X factors tend to be associated with the relatively urban areas in London, the south and the southeast (London, Southern, and Seeboard), where quality of service was relatively high. The higher X factors tend to be associated with the relatively rural areas in South Wales, North Wales and the southwest (Swalec, Manweb and SWEB). These companies would need more capital expenditure and hence

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[14] *Main Prospectus, The Regional Electricity Companies Share Offers*, Offers for Sale by Kleinwort Benson Limited on behalf of the Secretary of State for Energy, 21st November 1990, p. 37.

a greater increase in revenues in order to improve quality of service.

Table 1: X factors set by Government at privatisation for regional Electricity Company distribution business price controls

REC	X Factor	REC	X Factor
Eastern	0.25	East Midlands	1.25
London	0.00	Manweb	2.50
Midlands	1.15	Northern	1.55
NORWEB	1.40	SEEBOARD	0.75
Southern	0.65	SWALEX	2.50
South Western	2.25	Yorkshire	1.30

Source: *Main Prospectus* (see fn 9 para 40).

H. Sharing Efficiency Benefits Via RPI-X Price Controls

56. It has been emphasised that RPI-X price caps are different from US rate of return regulation. It will be helpful to explain a little further the differences and implications.

57. In the US, a traditional aim of regulation was to ensure that the utility earns a fair and reasonable rate of return, and does not earn an excessive profit at the expense of customers. There was relatively little emphasis on efficiency. In contrast, in the UK a main aim of privatisation was to increase efficiency. It was necessary to reassure investors and customers

by setting prices for a fixed period ahead but there was less concern about excess profit within any price control period.

58. This difference in aim is reflected in a difference in process. In the US, the regulatory commission allows a particular tariff after a rate hearing process. That tariff typically stands until the company files for a higher tariff (because its earned return on capital is turning out to be too low) or until the commission orders a hearing to consider a lower tariff (because the earned return on capital is turning out to be too high). This triggers another rate hearing process, another tariff is set, and so the process continues, with tariffs reset as and when profits tum out to be too low or too high.

59. In contrast, an RPI-X price control is set once-and-for-all for a specified period of years (typically four or five years). The price control is not reopened during that period, regardless of the level of profits or return on capital.

60. The US approach gave the company limited incentive to reduce its costs and increase efficiency because increased profits would trigger a resetting of its tariffs. The UK approach gave the regulated company greater incentive to increase efficiency because the company could keep the resulting profits during the specified (four or five year) price control period.

61. The interests of customers were not ignored. Increased efficiencies would be reflected in lower

prices in the price control to be reset at the end of the (five year) period. The new price control would take into account the extent to which costs had been reduced already, and could be still lower in future. The price control would be set to allow a reasonable (and not excessive) return on capital in future to an efficiently operated company. In this way, customers would share in the benefits of increased efficiency over the longer term.

62. Under the UK system, an exceptionally efficient company could still expect to earn an above average profit rate within each period, though the amount of that was never quantified. It was expected that the initial setting of the price control, and then the resetting of the price control for the next period, would limit the extent or duration of any excessive profits. But there was no explicit procedure during the course of any price control period to deal with profits that were perceived to be excessive.

I. Initial Experiences After Privatisation

63. Privatisation of the utilities was well received by investors. Initially, all the privatised utilities went to a premium over the flotation price. The Government had aimed for a small premium, but in some cases the premium went higher.

64. For example, the NAO found that the premium on the Regional Electricity Company shares averaged 49 pence over the first 24 days trading, compared to the target of 15 pence. However, the NAO found that, of the 49-15=34 pence

difference during the first 24 days, 30 pence could be explained by the general upward movement in the stock market after the issue was priced.[15]

65. Over a longer period it became apparent that the profits of the utilities were increasing to a greater extent than had been envisaged at the time of privatisation. A main purpose of privatisation generally, and of RPI-X incentive regulation in particular, was to promote the interests of customers with respect to prices and quality of service, and to do so by encouraging greater efficiency on the part of the newly privatised companies. Under the RPI-X approach, greater efficiency led directly to higher profitability.

66. Separately from its investigation of each utility flotation, the NAO investigated the extent to which the original aims of privatisation and incentive regulation had been achieved. By 1996, it found that, in real terms, prices had fallen by between 10 per cent and 44 per cent for domestic electricity, gas and telecommunications customers, and by between 9 per cent and 54 per cent for business customers.[16] By 2002, it found further price

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[15] As noted earlier (para 44 above), the NAO examined all the utility flotations. In general it concluded that the Government achieved its objectives, which included maximising proceeds. The Reports do not suggest that the Government sold those companies too cheaply.

[16] National Audit Office, *The Work of the Directors General ofTelecommunications, Gas Supply,* Water Services and

reductions. It also concluded that price cap regulation has been associated with efficiency gains in each industry, and that service reliability has also been maintained or improved. [17]

67. With respect to efficiency, the NAO said "In all of the regulated industries we looked at, companies have found ways of operating more efficiently. They have either reduced their costs during recent price control periods, or, in the case of water, where costs have increased to deliver improvements in quality, companies have incurred expenditure more efficiently."[18]

68. The NAO gave several illustrations of increased efficiency. For example, in telecommunications, BT's Network business achieved a weighted average rate of reduction in unit costs of 9.4 per cent up to 1999/2000. In electricity transmission, National Grid Company had reduced controllable operating costs by 50 per cent since 1990. In electricity distribution, each company achieved efficiency savings to varying degrees, but overall operating costs of these businesses reduced by around 25 per cent in the period 1994-95 to 1997-98. Water companies achieved substantial reductions in unit costs after 1990, outperforming OFWAT's (the Office

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Electricity Supply, He 645, 1995-96, as cited in National Audit Office, *Pipes and Wires*, He 723m 2001-02, 10 April 2002, at page 28.

[17] National Audit Office, *Pipes and Wires*, p. 25.

[18] National Audit Office, *Pipes and Wires*, p. 25.

of Water Services) operating expenditure projections by 6 per cent between 1989 and 1994 and by 9 per cent between 1994 and 1999.[19]

69. Regulators and companies understood that increased efficiency could lead to increases in profits in the short term. Profits did indeed increase. For example, the NAO found that in the first year after privatisation the twelve RECs achieved profits that were 22 per cent higher than forecast in the Prospectus.[20] Companies attributed these increases to the net outcome of developments that were different from the assumptions made at the time of privatisation. These included a colder winter leading to higher demand, and lower than expected electricity generation costs. The companies also explained that their profit forecasts had been conservative.

70. Profit increases continued beyond the first year mentioned by the NAO, not only for the RECs, but also for the other privatised utilities generally. The companies increased their efficiency and reduced their operating costs more than expected. To a significant degree, this was achieved by reducing the work force. Employees were willing to take the generous redundancy payments that were then on offer, and the companies were able to implement

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[19] National Audit Office, *Pipes and Wires*, p. 25.

[20] National Audit Office, Report by the Comptroller and Auditor General: *The Sale of the Twelve Regional Electricity Companies*, p. 13.

greater efficiency savings than expected. The companies incurred less capital expenditure than previously indicated. In addition, in the particular case of the RECs, an assumption about inflation used in setting the initial distribution price control allowed the companies a higher revenue path than was originally forecast.

71. Along with higher-than-expected profits went higher-than-expected dividends and higher-than-expected increases in share prices. For all the privatised utilities, share prices increased not only in absolute terms, but also relative to the general movement in stock market prices. Among the highest share price increases were those of the RECs. This represented a particular challenge for me as electricity regulator.

J. The Growing Concern About Excessive Profits

72. The increases in profits, dividends, and share prices of the privatised utilities caused considerable and increasing public comment and disquiet. Attention was also drawn to the increased salaries of utility directors and executives. Profit increases and share price increases often had an additional knock-on effect on the remuneration of these directors and top executives, via their share ownership and bonus schemes. It was alleged that they were being paid much more for doing essentially the same jobs as they had done before privatisation. The popular press came to call them "fat cats."

73. These public concerns were widely recognised. For example, one article refers to "the general, swingeing statements, often associated with commentators of the Left, that privatisation and the regulation process has allowed thousands of fat-cat executives to clean-up, for the customer to be ripped off by the privatised utility companies charging extortionate prices and that we need to boot out all the regulators and start out all over again."[21]

74. Regulators were in a difficult position here. Their duty included the protection of customers. They might have considered that, in retrospect, the initial price controls set by the Government were less severe than they might have been. Under the US regulatory approach, they would probably have stepped in and required a reduction in prices to achieve a more acceptable rate of return. But the RPI-X method of price control relied on regulators *not* stepping in to adjust prices until the end of the defined price control period, otherwise the incentive to efficiency would be lost. And over the longer term, customers could expect to benefit from the increased efficiency.

75. As electricity regulator, I was personally under public pressure to revise the price controls so as to reduce the profits of the electricity companies and to transfer to customers more of the benefits

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[21] Dan Corry, "Regulating in the Public Interest" in Dan Corry, David Souter, Michael Waterson, *Regulating Our Utilities*, Institute for Public Policy Research, 1994, at p.1.

of privatisation and efficiency improvements. I knew that, consistent with the RPI-X incentive regulation system, the reductions in costs and improvements in efficiency redounded initially to the benefit of the utilities' shareholders and only later to the benefit of their customers. However, this took time, and in retrospect the initial price controls set by the Government at privatisation did not fully anticipate the extent to which cost reductions and profit increases would be possible. As a result, customers and many other commentators took the view that the gains of privatisation were not being shared equally between investors and customers. They saw excess profits and were not yet convinced that regulators would in due course reset price controls to benefit customers.

76. There was much public concern about this. Customer groups and others urged regulators to intervene to reset the price controls prematurely. I and other regulators were reluctant to do this, since it meant breaking, or at best undermining, the assumptions underlying the RPI-X incentive mechanism. At the end of the initial price control periods, all the regulators tightened the price controls and thereby transferred more benefits to customers. Nevertheless, there remained a strong feeling that the utility companies had obtained excess profits in the initial periods, and that customers had not shared equally in the gains from privatisation.

77. As electricity regulator, I was particularly conscious of the situation of the Regional Electricity Companies (RECs). As explained above (paras 53-55), the Government had established RPI+X rather than RPI-X controls for each of the RECs. These provided for prices to *increase* in real terms rather than reduce, in order to finance a significant increase in capital expenditure. These X values ranged from 0 to 2.5—that is, the prices the RECs could charge were allowed to increase at up to 2.5 per cent per year plus the rate of inflation, depending on the company. In the event, the RECs did not increase their capital expenditures at the anticipated rate, and were able to considerably reduce their operating costs. The result was that the profits of the RECs increased to a greater extent than had been anticipated. So too did their share prices and dividends and executive compensation. Customers and others objected that all these excess profits, bad as they seemed to them to be, were accompanied by increases in electricity prices rather than by decreases.

78. While I sympathized with the concerns about profits and the need to share the benefits of privatisation, my own view was that it was important to allow the companies to retain the profits that they made within the pre-specified five years of the initial price controls. To revise the controls before then would have been a breach of faith with investors, which would have undermined the efficiency incentive principle that was fundamental to the price controls. In the longer term, customers would gain from

increased efficiency and lower costs in the industry, since over time these could be reflected in tighter price controls and lower prices. For this reason, I refused to intervene before the end of the five-year initial period. Instead, I commenced the price control review for the next period, and in due course reset the RPI-X controls on a considerably tighter basis for the next five years.

79. Even this review presented particular and unexpected difficulties. The new price controls that I proposed in August 1994 embodied a one-time price reduction varying from 10 to 15 per cent, followed by a real price reduction of X=2 per cent per year. However, a leak of an earlier discussion document had suggested that price reductions would be even greater than this. Announcement of the proposed reductions in prices was followed by increases in share prices, which suggested to some that the proposed price controls had not been sufficiently rigorous.

80. Towards the end of 1994, a bid was put in for Northern Electric, one of the RECs (RECs were protected from takeover until April 1995). This led to increases in share prices for Northern Electric, and for the other RECs too. In defending itself, Northern Electric proposed to borrow a very large sum of money and pay this back to shareholders. The prospect of other companies doing this too led to further share price increases. There was considerable press comment that the August price control proposal

had not drawn an appropriate balance between the interests of shareholders and customers.

81. In the light of the new information associated with the takeover, I reopened the proposed REC price control. I decided to reduce prices by a further 10 to 15 per cent (making a total reduction of about 25 per cent over two years), and to increase the subsequent real price reductions from X=2 to X=3 per cent per year.

82. I was able to propose such a significant and immediate price reduction because, for this first resetting of the price control, I was able to define the initial value of the REC assets that would enter the Regulatory Asset Base (RAB). This is the base on which the utilities earn their allowed rate of return. I decided that the RAB should reflect the price at which investors had bought the assets of the companies at the time of privatization (the flotation value), rather than the (higher) replacement value of the assets. A major part of the two initial price reductions reflected setting the initial value of the Regulatory Asset Base (RAB) ever closer to the flotation values of the assets. This was in addition to the price reductions made possible by lower operating costs and capital expenditure in the first period of the price control.

83. A thorough official investigation by the Public Accounts Committee acknowledged that the utility regulators were not responsible for the early levels of utility profits, and recommended that they take action to deal with them as soon

as consistent with the RPI-X approach. It concluded as follows:

> (vi) "We recognize that the Directors General were not responsible for the initial regulatory regimes, including the price controls, which applied in the industries they regulate in the period immediately following privatisation. We note that in the five years after privatisation the water companies made profits totaling £7.4 billion, and the regional electricity companies profits of £8.7 billion, and that in both cases the profits were in excess of the level that the respective Directors General have judged it reasonable to allow for in the future."
>
> (vii) "To avoid the risk that profits might again rise above a reasonable level we recommend that the Directors General set price controls which will ensure that profits should be no more than sufficient to provide the return required to attract the necessary funds for investment in futureperiods."[22]

84. The regulators did indeed revise the price controls in this way. As just explained (paras 79-81), I reduced the prices charged by the RECs by

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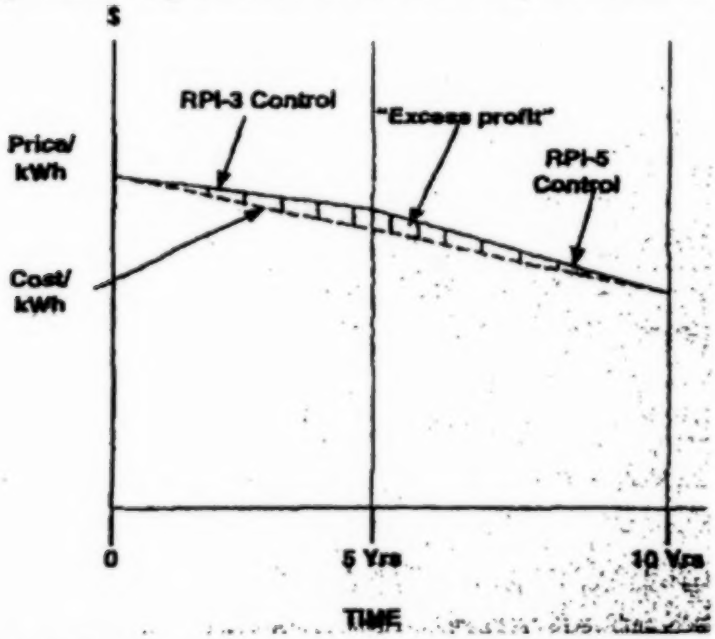
[22] *The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply,* Committee of Public Accounts, Sixteenth Report, House of Commons session 1996-97, London: HMSO, 5 March 1997. P vi.

nearly one third over the five years following the first price control period. Nevertheless, time did not diminish the widespread feeling that the profits of the privatised public utilities had been excessive, particularly in the early years after privatisation. Even though regulators had dealt with the problem as regards future profits, in my experience there was a continuing feeling that the utilities had secured and retained excess profits in the period of the first four or five years after privatization, and that 'something should be done about that.'

K. A Diagrammatic Illustration

85. Figure 1 illustrates in a stylized way one scenario of how the RPI-X price control might work in incentivising efficiency and transferring benefits to customers.

Figure 1.
Stylized Operation of RPI-X, Scenario 1



86. An RPI-3 price control might be set for the first five years, assuming that an efficient and incentivised company could reduce costs by 3% a year. This would give customers the benefit of prices reducing by 3% a year in real terms.

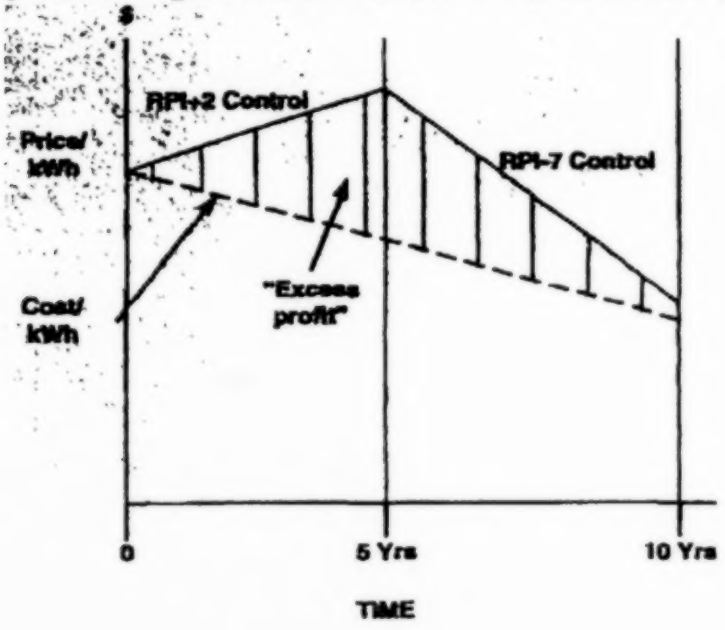
87. Suppose that, in the event, the company is able to reduce its costs by 4% a year, where cost includes a reasonable return on capital. Then the company would earn profits above this reasonable return, as indicated by the shaded area.

88. The regulator would then reset the control after five years. Suppose it expected that the company could continue to reduce costs by 3% a year. The regulator might set the control at RPI-5 to provide a "glide path" to the efficient level of

cost at the end of the tenth year. Customers would now benefit from prices reducing at 5% a year. By the end of the second five-year period, the "excess profits" in the shaded area—or what the regulators might call the "reward for superior efficiency"—would be eliminated. Customers and shareholders would both have benefited from the RPI-X incentive price control, and the "excess profits" would be seen as a reasonable price to pay for the efficiency benefits from which customers benefited too.

89. Figure 2 illustrates, again in a stylized way, another scenario of how the RPI-X control might work, leading to what might be perceived as excess profits and inadequate benefits for customers.

Figure 2.
Stylized Operation of RPI-X, Scenario 2



90. The Government expects that capital expenditure will need to increase significantly and that there is little scope for operating cost reductions. It may also be concerned to make sure that the company is attractive to prospective shareholders. It therefore sets an initial control of RPI+2, allowing prices to increase at 2% a year in real terms. In the event, the company does not spend all the expected capital expenditure, discovers greater than expected scope for operating cost reductions, and reduces its financing costs by increasing its borrowing (gearing or leverage). It manages to reduce overall costs by 3% a year.

91. At the end of the first five years, the regulator resets the price control. The regulator may believe that there is scope to continue to reduce costs by 3% a year, but cannot prove this, and has a duty to ensure that the company can finance its licensed activities. So the regulator assumes that an efficient company will reduce costs at 2% a year. On this basis, the regulator resets the price control at RPI-7. In the event, the company continues to reduce its costs by 3% a year.

92. The relatively large shaded area indicates that "excess profits" increase steadily over the first five years, to what many people regard as an unacceptable level for an unacceptably long period. This is particularly the case since prices are rising at the same time as profits. (In fact, if inflation were, say, 3% a year, then even a real

price reduction of 2% a year would translate into a nominal price increase every year.)

93. Even though the regulator resets the control after five years, the damage is done, in terms of public perception. Moreover, it takes time for the new reduction in prices to reduce excess profits, and typically they are by no means removed altogether. Even though customers have eventually benefited from the increased efficiency, they are left with the feeling that they have not received a fair share of these benefits. They have been exploited by the company and not protected by the regulator. In these circumstances, a windfall tax to remove some of the excess profits in the first price control period may seem an appropriate remedy.

94. In practice, each price control situation is different, and there are many complexities not reflected in the two Figures. (For examples I have explained that I reduced the electricity price controls with immediate effect at the beginning of the second period rather than allowed a "glide path" to lower prices at the end of the second period.) Nonetheless, the figures illustrate the nature of the problem that the Windfall Tax sought to address.

L. The Windfall Tax

95. In opposition, the Labour party had systematically opposed the utility privatisations that had been introduced by the Conservative Government. It was also highly critical of the high profits that followed these privatisations.

In the early days it talked of renationalising the privatised industries. But this failed to recognise the efficiencies that privatisation was increasingly bringing, and in some cases was impracticable. The Labour party also criticised the utility regulators that had been appointed by the Conservative Government. It was well aware of the strong public concerns on the issues of profits, share prices, and fat cats, and wished to respond to them. In this climate the Windfall Tax was born.

96. As early as 1992 it was proposed that a one-off tax should be levied on privatised utility companies. Mr. Brown (the future Chancellor of the Exchequer and later Labour Prime Minister) reportedly made a proposal to this effect. "[T]o finance a package which includes no spending cuts, a 'substantially bigger' jobs boost than Labour proposed in April, a package of grants and tax incentives for industry, and joint public/private infrastructure projects, Mr. Brown proposed a 'one-off public dividend' on the 'excess profits' of privatised utilities."[23]

97. I understand that the then Labour leader Mr. Blair committed the party to a windfall tax when launching the draft party manifesto in July 1996. It was much discussed publicly from then on. At this stage, it was not clear on what precise basis a Windfall Tax would be set. It was

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[23] *The Independent*, 10 November 1992, under the heading 'Labour ditches plans for income tax increases,' by Nicholas Timmins, Patricia Wynn Davies and Colin Brown.

not generally known what would be the criteria for calculating it, to which companies it would apply, and what the total proceeds would be.

98. The intention to impose a "windfall levy" on "the excess profits of the privatised utilities" in order to finance a "welfare to work programme" was explicitly incorporated into the Labour party election manifesto, published shortly before the election took place on 1 May 1997.[24] On that day the Labour Government was elected in place of the Conservative Governments that had been in place since 1979. It was elected by an overwhelming majority, indicating considerable public disapproval of the previous Conservative Government and its policies. It was clear that there was strong public support for taxing what were seen as the excessive profits of the privatised utilities.

99. The Government discussed strictly limited aspects of the Windfall Tax with all the utility regulators. It asked them to confirm that companies in their sector could afford specified possible levels of tax. I met with the relevant Minister (Mr. Robinson) to discuss this issue. I was in fact responsible for regulating 17 of the 32 companies to which the Windfall Tax applied.

100. On 2 July 1997, the new Chancellor of the Exchequer (Mr. Brown) announced details of the

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[24] "This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities, introduced in this Budget after we have consulted the regulators." *Because Britain deserves better*, Labour election manifesto, 1997.

tax as part of his Budget speech. He said that "[t]he Windfall Tax will be related to the excessively high profits made under the initial regime." This reference to "initial regime" means the initial period of price control for each company, typically four or five years after privatisation. During that period, the value of X in the RPI-X price control formula was the value fixed by the Government at the time of privatisation. The Chancellor repeatedly stressed the rationale for the tax. "Our reform of the welfare state ... is funded by a new and one-off tax on the excess profits of the privatised utilities."

101. Parliament passed the Windfall Tax Statute later that month, and it became law. It defined windfall profit as a multiple of the profits of a privatised company in the first four years after flotation. The tax was levied on a total of 32 privatised companies in the telecommunications, gas, airports, water and electricity and rail sectors. It raised £5.2bn in total, payable in two equal instalments, one on 1 December 1997 and the other on 1 December 1998. The 12 RECs paid £1.45 billion in aggregate, just over a quarter of the total.

102. As for the rationale for the tax, I have referred to the evidence that profits were indeed greater than expected and the widespread concern about excessive profits. In my own experience, customers writing to complain to the regulator, and commentators making critical comments in the media, covered a range of issues but mainly

focused on excess profits and associated phenomena. There were concerns about various different causes of increases in profit. There were concerns about dividends, share prices and executive remuneration, but these were typically associated with, and followed from, the increases in profit.

103. I was aware of claims that the privatized utilities had been sold too cheaply. With respect to the period immediately after privatisation, the National Audit Office examined this issue and provided no basis for concluding this, and I have no reason to question the NAO's report. With respect to the whole period during which I was regulator, I do not recall receiving complaints to this effect, nor much emphasis on this issue in the media relative to the concerns about excess profits. I am sure that no one who complained about the privatized utilities would have been assuaged if the utilities had been sold at a higher price.

104. In my view, therefore, it is plausible to see the Windfall Tax as a tax on excessive profits, as the most senior Labour Ministers always stated it to be. It is not plausible to see it as a means of addressing a concern that the utilities were sold too cheaply. M. Conclusions

105. During the 1970s, the inefficiency of the state-owned industries was a major public concern. A main aim of privatisation, and regulation of the privatised utilities, was toimprove efficiency.

106. RPI-X was a new incentive-based approach to regulation, different from the US rate of return approach. It was initially designed in 1983 to provide assurances to customers and potential shareholders of British Telecommunications, which was about to be privatised, while encouraging greater efficiency. This approach did not regulate profits, and accepted that greater efficiency could lead to higher profits during the period of the price control.

107. With the exception of the three electricity generating companies, which were regarded as operating in a competitive market, RPI-X incentive price controls applied to all the utilities in the UK that were privatised during the period 1984 to 1996. With the same three exceptions, RPI-X price controls applied to 29 of the 32 companies subsequently subject tothe Windfall Tax.

108. After each utility privatisation, the NAO issued a Report into how far the Government achieved the objectives that it set for itself with respect to the sale in question. In general, the Report concludes that the Government did achieve its objectives. The Report does not suggest that the Government sold those companies too cheaply.

109. A main purpose of privatisation generally, and of RPI-X incentive regulation in particular, was to promote the interests of customers with respect to prices and quality of service, and to do so by encouraging greater efficiency on the part of the newly privatised companies. The NAO found that these objectives had been achieved.

110. The utility companies were able to increase efficiency by reducing capital expenditure and cutting their operating and other costs to a greater extent than previously expected. This in turn led to higher profits than expected. The NAO confirmed this, and said that profits were in excess of the levels that the regulators judged it reasonable to allow for in future.

111. These higher profits led to higher dividends, higher share prices, and higher executive compensation than expected. These outcomes led to considerable public concern. The utility profits were widely perceived to be excessive.

112. The initial RPI-X price controls were set by the Government. When the time came for the utility regulators to reset the initial price controls, each utility regulator tightened the initial price control with a view to removing or reducing the excess profits during the next price control period. Nonetheless, by that time the damage had been done in terms of public perception, and public concern about excess profits continued.

113. In 1992, the Labour party proposed a windfall tax on the excess profits of privatised utilities. The intention to impose such a tax on excess profits was explicitly incorporated into the Labour party's manifesto before the general election of 1 May 1997. In his Budget speech, the new Chancellor of the Exchequer (Mr. Brown) said that "the Windfall Tax will be related to the excessively high profits made under the initial regime."

114. In my experience as electricity regulator, I received many complaints about excessive profits. I do not recall receiving complaints about the utilities being sold too cheaply. 115. In my view, therefore, it is plausible to see the Windfall Tax as a tax on excessive profits, as the most senior Labour Ministers always stated it to be. It is not plausible to see it as a means of addressing a concern that the privatized utilities were sold too cheaply.

115. In my view, therefore, it is plausible to see the Windfall Tax as a tax on excessive profits, as the most senior Labour Ministers always stated it to be. It is not plausible to see it as a means of addressing a concern that the privatized utilities were sold too cheaply.

[Exhibits omitted in printing this appendix]

EXHIBIT 139-P

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Report of Chris Osborne
On Behalf of PPL Corporation and Subsidiaries

September 8, 2008

[Table of Contents omitted in printing this appendix]

1. Introduction and summary of conclusions

1.1 My name is Chris Osborne. I am employed by LECG, an expert services firm, which carries out a mix of work on economic regulation, competition (anti-trust) issues, valuation, and litigation support—by which I mean the provision of expert testimony, generally on

matters related to the calculation of damages in civil litigation or in commercial or treaty arbitrations. Within LECG I am responsible for all international operations, and recently took on responsibility also for the firm's operations in New York.

1.2 My own clients include regulators and law firms, and I am myself regularly called to give expert testimony on damages. I am a Fellow of the Institute of Chartered Accountants in England and Wales—and therefore a qualified accountant—and I have a masters' degree in economics.

1.3 Before 2002, I was a partner at Arthur Andersen, during which time I was worldwide head of Arthur Andersen's Economic and Financial Consulting Group. In 1996 I worked on a project carried out by Arthur Andersen on behalf of the British Labour Party, to develop a structure for a windfall tax on the UK's privatised utilities. I am one of the two people who conceived and then oversaw the development of that tax; the other being Chris Wales, then a fellow partner at Arthur Andersen specialising in tax matters.

1.4 I have been asked by Hunton & Williams both to describe my involvement in the development of the tax and to give my opinion as to its underlying purpose and nature. In relation to this work LECG has submitted invoices to date for a total of £218,386, which sum includes inter alia my own time at my normal billing rate of £520 per hour, and amounts in respect of Dr.

Wales. My conclusions are set out in Section 4, following some necessary background in Section 3. In summary:

- The popular rationale for the tax was undoubtedly the level of profits earned by the newly privatised utility companies.
- More specifically, the rationale for the tax that we adopted for the purpose of its design was the level of profits earned by the companies in the period *immediately subsequent to flotation.*
- Although all of the companies subject to the tax were also subject to formal price regulation, in general there was a period immediately subsequent to flotation in respect of which prices were set by the Government, and during which the companies were able to make profits in excess of those anticipated at the time of flotation.
- After this period (which in general was a five year period) the prices that the companies were allowed to charge were re-set by industry-specific regulators. The nature of that price-setting process was that prices were set so as to allow the companies to earn a reasonable rate of return on their initial flotation value, adjusted *inter-alia* for subsequent investment.
- It had in most cases become apparent, however, that during the period immediately subsequent to flotation, and prior to prices being reset by an industry-specific regulator,

initial prices had been set at a level which had allowed the companies to earn profits which in relation to their flotation value were *more than* reasonable, and that therefore could be described as *excessive*.

- The rationale for the tax was rooted in this initial period during which excessive profits were made, as judged against the companies' flotation values.
- The nature of that judgement means that there is a logical symmetry between the two available ways of describing the rationale for the tax—that profits were high in relation to the flotation value, or that the flotation value was low in relation to profits. There were important presentational reasons for choosing the latter; but they were from my perspective essentially presentational.

1.5 In short, the objective of the tax was to reach the profits made by the relevant companies during an initial period subsequent to privatisation during which many of the companies made profits which could be, and were, popularly, described as excessive.

1.6 The tax was not designed to be a tax on value. Although the relevant companies were sometimes described as having been sold *too cheaply*, it was my firm belief at the time, and remains so, that in essence this was a judgement that could only be made with hindsight. With hindsight, it could be said that the profits that were made—realised—were high

or *excessive* in relation to the flotation price. Nobody to my knowledge has ever argued that those profits were or ought to have been *foreseeable* at the time of flotation—nor do I believe that such an argument could reasonably be made.

1.7 For the same reason, the *value in profit making terms* described in the wording of the act by which the tax was brought into law is not a real value: it is rather a construct based on realised profits that would not have been known at the date of privatisation, and a mechanism by which additional taxes on those profits could be levied.

2. Biographical background

Education

2.1 I was born in 1961, and I am now 47 years old. I received a scholarship at Winchester College in England, where I studied Physics, Maths and English to A-level. I gained a first degree in Civil Engineering from the University of Bristol, graduating in 1982. I joined Arthur Andersen in the same year, and LECG in 2002. I subsequently gained a Masters' degree in economics in 2006.

Early career

2.2 Until 1986 my work at Arthur Andersen was predominantly in the audit area. During this time I qualified as a chartered accountant. I then spent a year in New York, during which I spent some time working on the analysis of a legal case in which Arthur Andersen itself was

the defendant—an action brought by the British Government in connection with Arthur Andersen's role as the auditor of the deLorean company.

2.3 The details of that case are not I believe important for the purposes of this document, but the consequence of the action being brought are. Arthur Andersen was, explicitly, prohibited ('black-listed') from doing work either directly for the UK Government or indirectly for entities financially controlled by the UK Government. The relationships that the firm had had, up until that time, with publicly owned entities such as The Thames Water Board had by then been terminated.

2.4 I returned to London in 1987 and joined a group focused on financial consulting—broadly speaking, valuation work applied in litigation and other contexts. In 1990, one of the partners in the group arranged for me to spend several months on secondment to Thames Water plc—the relatively newly privatised company that had responsibility for the water supply and extraction services previously carried out by the Thames Water Board.

2.5 Thames Water, as a private sector monopolist, was subject to a price control of the "RPI-X" kind. Although the company was only recently privatised, the regulatory body overseeing the price control was considering a revision to that control, on the grounds that the prices allowed were too generous.

2.6 My role was to understand and model the nature of the price setting process, and the scope of the price reductions that might be required. The work that I did suggested that there was significant scope for the regulator to argue for additional price reductions. In the event, the price control was strengthened by 0.5%—a relatively small amount in percentage terms, but far from trivial in its impact.

2.7 To illustrate the point: Thames Water at that time had revenues that were of the order of £500 million per year (rounded for convenience in this example). A half percentage point reduction in the allowable rate of increase in the prices that they were able to charge would then be worth:

- £2.5 million in the first year (i.e. 0.5% of £500 million)
- £5.0 million in the second year (i.e. the 0.5% reduction in the previous year, plus a further 0.5% reduction in the current year)
- £7.5 million in the third year (for similar reasons); and
- £10.0 million in the fourth year.

2.8 Prices were then in any case due to be reset in the fifth year, but the effects of an interim 0.5% reduction in allowable prices were of the order £25 million over the years that the revised price control would then be in force. This was significantly less than I had calculated that the regulator could have insisted upon, but was

nevertheless, as I have noted, a significant reduction.

2.9 At some point in 1991, I was asked by the managing partner of the London office, Roy Chapman, to work with an audit partner, Stephen Hailey, on a project that involved key members of the British Labour Party. My understanding at the time and subsequently was that Arthur Andersen were keen to have the ban against them—on doing work for Government entities—lifted. We would do the work for the Labour Party, and if they were successful in the General Election the question of the ban might be re-visited.

2.10 Once again, the details of the work involved are not important to this document. I spent some time reviewing the UK's national accounts and wrote a paper that was subsequently published under the heading *Financing the Future*. The paper dealt with an issue which has since become commonplace—the tendency of Government cash-based spending controls to discourage investment.

2.11 In the event, the Labour party lost the election of 1992. John Major, the leader of the Conservative party, retained power; and Arthur Andersen remained blacklisted. I became a partner in the firm, and continued to work with clients in and around the regulated industries.

2.12 In the period up to 1996, I worked with companies in all of the regulated industries. The next section gives a more thorough description

of the nature of price regulation and the companies to which it was applied, and will give a better idea of the issues on which I worked. At this point it is worth noting that I worked with companies in the electricity, gas, rail, telecoms and water sectors. I worked for regulators, for incumbents, and for new entrants; both in the UK and abroad. I was regarded within Arthur Andersen as expert in matters related to the economic regulation of the privatised utilities.

2.13 It may also be worth noting that throughout this period Arthur Andersen remained blacklisted by the Government. It was therefore very difficult to secure work with the economic regulators, who despite being in principle independent of central government control were nevertheless subject to central government spending rules. The work that I did during this period for the rail regulator and for the gas industry regulator was secured in spite of central government rules that Arthur Andersen could not be hired by government entities.

2.14 In 1996, and with another general election approaching, I was again asked by Stephen Hailey to consider doing some work on behalf of some key members of the Labour party. The issue on this occasion concerned the potential imposition of a "Windfall Tax" on some or all of the privatised utilities.

2.15 The Labour party's plans to impose a tax on the excess profits of the privatised utilities had by then been widely publicised, so the issue was not in any sense new to me at the point when it

was raised by Stephen. Press reporting at the time was not unsympathetic, since the companies were enjoying record profits, and paying substantial bonuses to their executives that were generally perceived as excessive.

2.16 Notwithstanding this, my own belief was that any such tax would be retrospective and inherently undesirable. The privatisation process had resulted in substantial foreign investment in the UK, and I believed that the flow of foreign investment could only be harmed by a signal from Government that taxes might be retrospectively levied. I believed, in short, that the tax was a bad thing.

The windfall tax project

2.17 Although I believed that the windfall tax was a bad thing, I could see the potential advantages for Arthur Andersen in assisting a potentially incoming Labour government in this way. As I have noted above, in my own area of work I was periodically confronted with the effects of the government black-listing of Arthur Andersen, and I was keen to see it lifted. More importantly, I felt that a poorly constructed windfall tax would be more damaging than a well constructed one. I therefore agreed to participate in the project.

2.18 The team that was put forward also included Chris Wales, a tax partner. I had not worked with Chris Wales before (and indeed there would not normally have been any reason to have worked with him) but we quickly settled

into an effective working relationship, in which he focused on tax-related matters and I focused on building the analytical tools that would allow us to assess the impact on individual companies of a given level and structure for the tax itself. Stephen Hailey operated as the primary contact point for the client.

2.19 Our work on the development of the tax is described in Section 4 of this document. Prior to describing that work, however, I believe it is important to give some additional background into the privatisation process, the way in which the UK's economic regulators set allowable prices for the privatised utilities, and the way in which excess profits arose in the periods immediately following privatisation. This background is set out in the next section.

3. Background to the regulated industries

The origins of the privatisation program

3.1 Privatisation is the transfer of ownership or control of publicly-owned assets to the private sector. More generally, it has also been used to describe the subcontracting or outsourcing of services, previously undertaken by the government, to the private sector, as well as market liberalisation or the introduction of competition.

3.2 The Labour Government under Prime Minister Callaghan undertook a major privatisation in May 1977, when it sold a 17% shareholding in British Petroleum Company Ltd to private shareholders. Due to the weight of Government

debts, the IMF placed significant pressure on the Callaghan Government to raise funds quickly. By selling shares in nationalised industries the Government could raise a considerable sum of money quickly. This sale was, therefore, more out of necessity than political judgement, and in the subsequent period, Labour remained politically opposed to the Conservatives' privatisation programme.

3.3 The Conservative manifesto in the run up to the 1979 General Election focused on the necessity to 'roll back the state' and introduce what was regarded as a more economically liberal approach by cutting taxes and reducing the growth in money supply. The manifesto promised to "*scrap expensive socialist programmes*" and to "*cut income tax at all levels*".[1]

3.4 The Conservatives gave a commitment to "*offer to sell back to private ownership the recently nationalised aerospace and shipbuilding concerns, giving their employees the opportunity to purchase shares*", and stated the aim to "*...sell shares in the National Freight Corporation to the general public in order to achieve substantial private investment in it*".[2]

3.5 On the back of these manifesto commitments, there was a significant privatisation programme in the first term of the new Conservative

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[1] Sections 2 and 3 of the 1979 Conservative manifesto.

[2] Sections 2 and 3 of the 1979 Conservative manifesto.

Government. It is important to note, however, that, the privatisation programme undertaken in the first term was of a different nature to the subsequent privatisation programmes. It focussed on returning companies to private ownership that were not, in the main, monopolies (having private sector analogues either in the UK or internationally). These companies did not, therefore, require specific economic regulation.

The progress of the privatisation program

3.6 During the second term of Conservative Government (from 1983 to 1987) there was a noticeable change in political views with respect to privatisation. There was, for example, a much more explicit recognition of a privatisation policy, with the Conservatives' 1983 election manifesto, stating that "*We shall transfer more state-owned businesses to independent ownership*".[3]

3.7 Given that the Government had already sold off what were viewed as the most obvious candidates for privatisation, it turned its attention to the larger monopoly utilities. The monopoly status of these companies required the establishment of economic regulators to implement price controls. These regulatory structures are described in more detail below. It was these companies that were subsequently accused of making windfall profits in the early

[3] Conservative Party manifesto 1983.

years after their privatisation, and on which the windfall tax was ultimately imposed.

3.8 British Telecom was partly privatised in 1984, British Gas in 1986 and the British Airports Authority in 1987. The first two were strongly opposed by the then opposition Labour Party, with an indication that the companies would be renationalised as soon as the Labour Party regained power. The subsequent privatisations (in the Conservative Government's third term) of the water companies in 1989, and the electricity companies in 1990 prompted less of a reaction—perhaps because the ideological battle for public ownership was being lost, or perhaps because of the substantial sums involved.

3.9 In the run up to the election in 1992, Labour policy was more focused on constraining the profits being made by the privatised utilities than it was on renationalisation. It was clear that renationalisation would be costly, and, given the extent to which the voting public had embraced share ownership, potentially unpopular.

The regulation of private sector monopolies

3.10 The prices that the UK's privatised monopoly industries are allowed to charge to consumers are regulated for the most part by industry-specific bodies established for this purpose as part of the privatisation process. Thus British Telecom was initially regulated by Oftel (The Office of Telecoms Regulation); British Gas was

initially regulated by Ofgas (The Office of Gas Supply); and the Water and Electricity companies were initially regulated by Ofwat (The Office of Water Services) and Offer (The Office of Electricity Regulation)[4].

3.11 The specific approaches followed in setting prices varied between regulatory bodies, but all followed the overall conceptual framework commonly referred to as "RPI-X" by which prices are allowed to vary from year to year to allow for inflation (the Retail Price Index, or RPI) less an amount intended to reflect increasing efficiency (the X factor). The X factor is reset periodically—typically every 5 years—rather than annually.

3.12 In some cases, particularly where investment requirements were high (and in many cases the companies had under-invested while under public ownership), the X factor was either explicitly positive (giving price increases *in excess of* RPI), or the path of allowed prices was expressed differently (as for example RPI-X + Q) incorporating a Q factor to give explicit recognition of the need to raise prices to allow for investments in improving quality.

3.13 The salient feature of this framework is not in fact its use of RPI, or even its use of an X-factor. The salient feature is rather that prices are reset only periodically. With a given set of

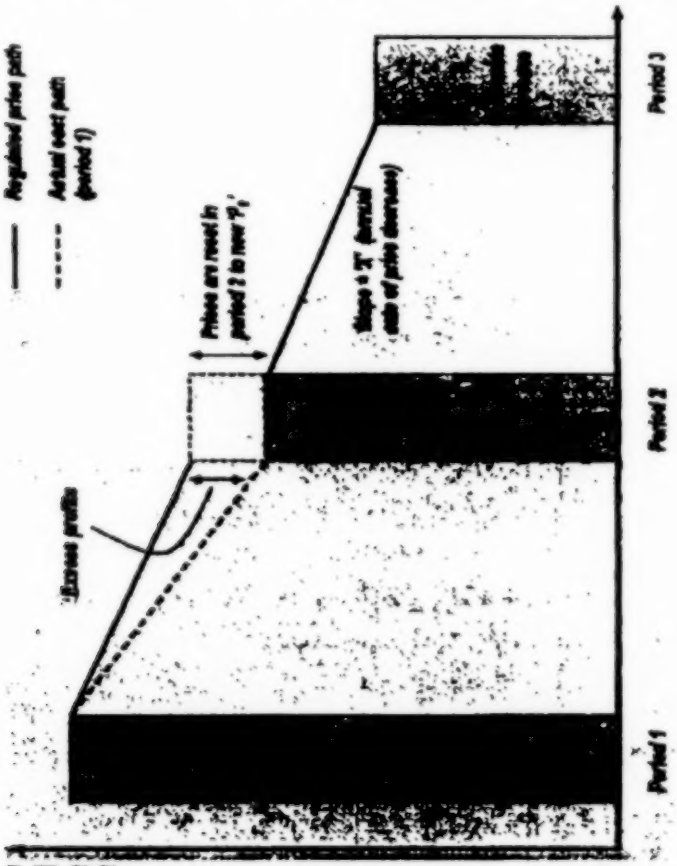
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[4] Oftel is now Ofcom (The Office of Communications), and Ofgas and Offer were merged to form Ofgem (Office of Gas and Electricity Markets).

prices, a company is then in a position to increase its level of efficiency, reduce its costs and increase its profits. When prices are next reset, they will be ratcheted down to the point that they reflect the level of costs then applicable.

3.14 Most importantly, the framework contemplates that excess profits will be earned, but that these excess profits will serve to demonstrate the scope for subsequent price reductions—which will be captured in the next price review, to the benefit of consumers. Alternative forms of economic regulation do not have the same strength of incentives for companies to reduce their costs. The operation of the framework is shown graphically below, for an example in which X is positive, such that prices fall in real terms.

Figure 1 Periodic reviews in RPI-X regulation



Source: LECG

The initial price controls

3.15 Notwithstanding that for each privatised utility there was an economic regulator with specific duties to control prices, in each case the initial price levels and price limits were set by the Government immediately prior to privatisation. Typically the RPI-X formula was fixed for a 5 year period.

3.16 The initial price controls for each industry are set out in the table below. I do not know the precise basis upon which the initial price control

targets were set, although I understand that, at least in some cases, the targets were agreed with the management of the companies concerned. Given the inherent volume growth of the monopoly businesses and the fact that the cost bases were largely fixed, the implied efficiency gains were relatively small.

3.17 The National Audit Office ("NAO") reports on the privatisations say that the valuations were based on anticipated dividend yields, but also took into account a desire that the privatisations should be successful. The reports also note that the subsequent gains in efficiency were neither anticipated nor foreseeable at the time that the original flotation prices were set. That is a point to which I will return later.

3.18 The important point to note here is that the linkage between the initial values at privatisation and the prices permitted under the price controls was of a different, and looser, form than the linkage that would subsequently be enforced in later price controls. Initially, prices were set, implied cash flows were determined, and investment advice determined the potential flotation value, based on a mix of quantitative and qualitative considerations. In subsequent price controls, as explained below, prices were more directly driven by a derived rate of return applied to a regulatory asset base.

Out-performance and subsequent price controls

3.19 All of the privatised utilities out-performed the efficiency targets implied by their initial price controls. This out-performance can be (and was) understood as making excess profits, but its effect was also that it allowed regulators to reduce prices faster (or increase them more slowly) in the second price control period:

Table 1 Tightening price controls following out-performance

	Gas	RECs	WaSCs	BT
Initial Price Control	RPI–2.0%	RPI+1.3%	RPI+3.9%	RPI–3.0%
First Year of next price control	RPI–5.0%	RPI–14%	RPI+1.5%	RPI–4.5%
Incremental price reduction	–3%	–15.3%	–2.4%	–1.5%

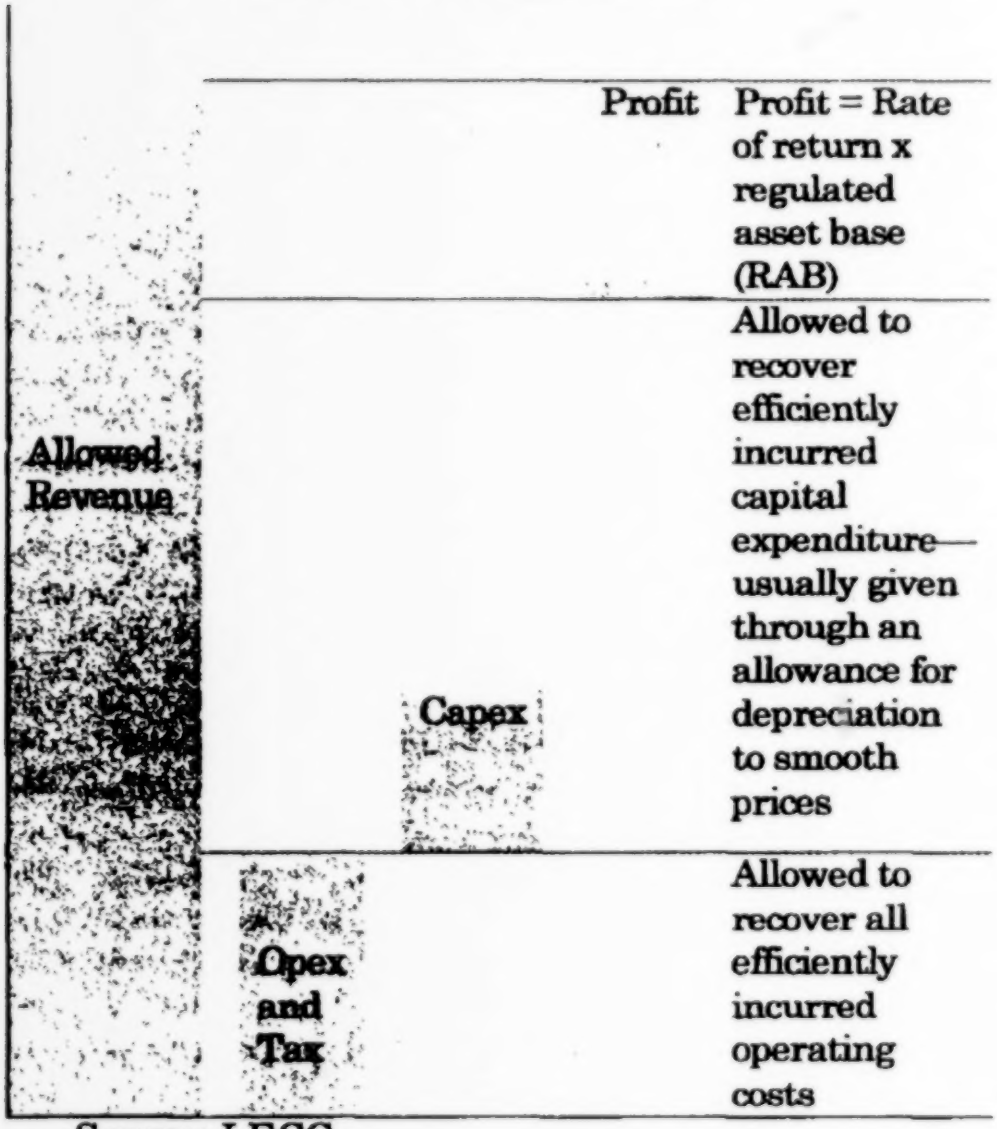
Note: For each sector, the price changes are presented on a year-by-year basis and are expressed as an average annual rate of change relative to RPI. Thus, a change of zero implies that prices would keep pace with RPI. Negative values in the table imply that prices were required to fall relative to the RPI.

3.20 The logic by which prices were set in the second and subsequent price controls was initially different across different industries, but converged over time with increasing recognition that prices need to be set in such a way that

they allowed a reasonable rate of return (given reasonable ex-ante assumptions as to the level of efficiencies that might be realised and the scale of investment required) on a measure of value that became known as the *regulatory asset base*.

3.21 The diagram below illustrates this model where the allowed revenue is a result of the sum of expected operating expenses, taxes, capital expenditures required to enhance/maintain levels of service, and a 'fair' return—a profit allowance—for the investors.

Figure 2 Assessment of allowed revenue in price cap calculations



Source: LECG

3.22 There was for some time an element of disagreement as to the how the level of the regulatory asset base should be set. Economic theory suggests that there are advantages in setting the level at around the replacement

value of the assets employed in the business (and indeed that is in principle how prices were set for many US utilities at the time). The advantage of that approach is in part that it results in prices being set at a level that would allow a potential entrant to enter.

3.23 The problem with an approach based on replacement values, however, was that for several companies—most notably the water companies—the replacement value of assets was significantly greater than the market value of the companies as of flotation. Setting prices on the basis of replacement costs would have resulted in sharp increases in prices, and profits; and would have meant that share prices would then have risen dramatically. Shareholders would have been over-rewarded.

3.24 Equally, the theoretical advantage of encouraging potential entry is unhelpful in practice. Nobody would actually contemplate duplicating an existing water and sewerage pipeline network, or suggesting that water prices should rise just to ensure that someone could. A consensus emerged during the first half of the 1990's that the regulatory asset base ought to be founded on initial market values at privatisation, adjusted from that date for incremental investment carried out by the company.

3.25 The price controls carried out by industry regulators during that time broadly followed this philosophy, and it remains essentially in place today for the purposes of price setting for

monopoly networks. Within this regulatory construct, the regulator sets prices such that there is a reasonable expectation of the company making normal profits over the price control periods; and the company strives to improve efficiency so as to make excess profits, notwithstanding that the impact of the regulatory regime is that those excess profits will be eliminated through lower prices at the next price control round.

3.26 In general, the process has worked: the companies have succeeded in outperforming; have thereby made excess profits; and prices have as a result fallen significantly over time.

3.27 The excess profits that are made in this framework are the result of outperformance against prices explicitly set by reference to a regulatory asset base linked to initial privatisation proceeds. The excess profits made in the first price control period after privatisation, however, are in a sense anomalous: initially prices were set exogenously, and flotation values were then established on the basis of a broad set of considerations; while subsequently prices were explicitly linked to privatisation proceeds.

Public reaction to increasing profits

3.28 Although it may therefore be said, as a matter of economic theory, that excess profits in the privatised utilities are a good thing—since they act over the long term to bring prices down for consumers—they have not in general been

perceived in that way. Particularly in the early 1990's, the public reaction to the increased profits in the gas and electricity sectors was pronounced.

3.29 The public reaction was fuelled in part (and perhaps largely) by the increases in salaries awarded to senior executives post privatisation—often referred to at the time as *Fat Cats*. Many of these were the same people who had been paid modestly to run the businesses when they were under public ownership, and the perception was that the demands of their jobs had not changed significantly since. Cedric Brown, the chief executive of British Gas in the first half of the 1990's, was the main victim of this reaction. In a mixing of animal metaphors, he was portrayed in the press as a pig; and at the 1995 shareholders' meeting a 500lb pig—labelled "Cedric"—was prominently and pointedly paraded outside of the meeting.

3.30 Also notable in this period was the performance of the RECs (the Regional Electricity Companies) in which the scope for efficiency gains post-privatisation had proved significantly greater than originally anticipated. The table below compares actual pre-tax profits (on a historic cost basis) with those *expected* at privatisation for a selection of companies. The numbers identified as expected are taken from projections contained within a broker's report

prepared by Laing & Cruickshank[5] and issued immediately prior to privatisation.

Table 2 Actual v. Expected pre-tax profit (HCA) in selected RECs

£ million		1990 /1	1991 /2	1992 /3	1993 /4	1994 /5
Eastern	Actual	123	143	183	177	204
	Expected	88	142	145	158	175
East Midlands	Actual	114	150	155	51	214
	Expected	76	124	127	140	156
London	Actual	136	143	146	187	172
	Expected	77	127	128	138	150
SWEB	Actual	63	83	101	117	100
	Expected	40	71	74	82	92

Sources: "Electricity: Key Questions On the RECs—Industry report" by Laing & Cruickshank, 15 November 1990, Eastern Electricity plc accounts 1991 to 1995 (YE 31 March), East Midlands Electricity plc accounts 1991 to 1995 (YE 31 March), London Electricity plc accounts 1991 to 1995 (YE 31 March), South Western Electricity plc

[5] Laing & Cruickshank was at the time a prominent analyst and broker firm. They were acquired by UBS in 2004.

accounts 1991 to 1995 (YE 31 March); 1995 as restated

3.31 The performance of the REC companies was therefore far stronger than analysts expected at the time of flotation. The stronger than expected performance of the REC companies can be seen in the share price movements shown in the graph below, which illustrates the large returns which investors in the RECs derived after flotation. After one year, for example, the shares had outperformed the FTSE All Share Index by some 29%[6]. That outperformance was sustained in later years up to the point that the companies were acquired. It is apparent, however, that the pattern of share price appreciation is consistent with progressive outperformance against expectations, rather than with any sudden realisation on the part of investors that the shares were under-valued.

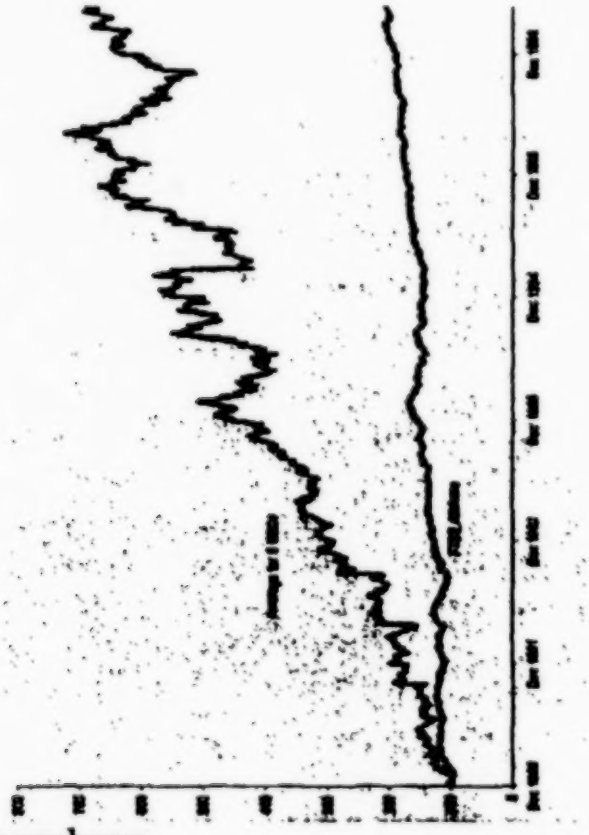
3.32 The National Audit Office, which carried out a review of the flotation of the RECs in 1992, did not find any evidence that the shares had been underpriced at flotation. They noted that the share premium averaged 49p for the first 24 days trading, but that 30p of that premium was attributable to a general upward movement in the market, and that "*most of the 19 pence balance was equivalent to the Department's*

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[6] LECG calculation. Some commentators calculate slightly different figures depending on the treatment of partly paid shares.

target premium of 15 pence, leaving about four pence unexplained"[7].

Figure 3 Performance of REC shares against the FTSE All Share Index



Source: Bloomberg.

Notes: Values are scaled to 100 at 11/12/1990, data was only available for 8 of the RECs.

3.33 Notwithstanding that conclusion, there was at the time significant public criticism of the then electricity industry regulator, Professor Stephen

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[7] NAO (1992) "Report by the Comptroller and Auditor General: The Sale of the Twelve Regional Electricity Companies".

Littlechild, for not intervening more quickly to constrain the profits being made by the electricity companies. It is my own view that the criticism was badly misplaced. It is one period's excess profits that drive the next period's price reductions, and reducing companies' incentives to earn excess profits (by acting to remove them within a price control period) serves only to reduce companies' incentives to strive for greater efficiency, thereby keeping prices higher over the longer term.

The idea of a windfall tax

3.34 Labour had been opposed from the start to the Conservatives' privatisation programme. It became apparent, however, that the option of renationalisation was not politically available, and additional policy options came to be considered. The change in leadership of the party after 1992, following the unexpected death of John Smith, and the resulting shift in economic thinking towards the political centre, was an important part of this process.

3.35 It was reported in the press as early as 1992 that the policy of an incoming Labour Government might include "*a 'windfall' tax on the profits of privatised utilities such as gas and electricity.*" The Daily Mail noted, for example, that in order to fund public sector pay rises and capital projects to create jobs for construction workers, the then Shadow Chancellor Gordon Brown suggested a windfall tax:

> *"He won't utter a word to offend the public sector unions. Instead, he retreats into the easy populism of suggesting a 'windfall' tax on the profits of privatised utilities such as gas and electricity"*[8]

3.36 The fact that the idea of a windfall tax could be described as *easy populism* illustrates the extent of public disaffection with the gas and electricity industries in particular. The Labour leader, Tony Blair committed the party formally to the tax when launching the draft manifesto in July 1996[9]. The policy was very much in the public domain from then on.

3.37 The policy was affirmed in Labour's 1997 manifesto in the run up to the General Election in May that year[10]. The manifesto committed the incoming Labour Government to introducing a budget:

> *"...to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities..."*[11].

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[8] Daily Mail, 10 November 1992.

[9] Independent, 5 November 1996, Blair gets backing for draft manifesto and Telegraph 4 July 1996, Labour promises a windfall tax on utilities.

[10] 3 April 1997 - The 1997 Labour Party Manifesto.

[11] 3 April 1997 - The 1997 Labour Party Manifesto.

4. The windfall tax project

4.1 Arthur Andersen's work on the windfall tax started sometime in June of 1996. I should add here that the majority of dates listed in this section of the document are based upon my personal recollection, and are therefore stated in approximate terms.

4.2 As noted earlier, Chris Wales and I were the individuals at partner level engaged in the work itself. We were both assisted by project managers, both of whom had more junior staff working for them.

4.3 During the project we had regular meetings with both Geoffrey Robinson and Ed Balls, who at that time was an economic adviser to Gordon Brown. Those meetings took place either at Arthur Andersen's premises or at Geoffrey Robinson's flat. At one of those meetings, as described in Geoffrey Robinson's subsequent book, we agreed the scope of the project:

- To examine the extent to which the privatised utilities might be able to bear an additional tax on a one-off basis
- To consider the way in which such a tax might be structured
- To estimate the potential yield from different taxing mechanisms
- To consider the wider implications of the windfall tax proposal

4.4 It should be noted that the purpose of setting out the scope of work in this way was not, or not

primarily, to clarify the nature of the work to be done. Rather, the purpose was to allow Arthur Andersen to emphasise, should it ever become necessary to do so, that the work had been objectively carried out and that the scope of work had been limited. Several of the companies who would pay the tax were Arthur Andersen clients, and the potential for embarrassment was real.

4.5 In reality, the scope of the work was clear: the Labour party had made commitments to programs that required funding, and other commitments not to increase general tax rates. The privatised utilities were a politically viable target for the tax, in part because they were perceived as having made large profits, and in part because they were perceived as having over-compensated their existing executive teams. The nature of the assignment was to design a tax that would be responsive to these issues.

4.6 While politically relevant, the *Fat Cat* issue was not in reality one that could sensibly be incorporated into the design of the tax. Executive remuneration is in general a very small fraction of the cost base of a utility company, and however offensive the levels might have been from a public perspective, the amounts involved were simply too small to be used to generate a significant tax yield. The key point was therefore the level of profits that had been made.

4.7 In my case the initial task was to gather information on the financial results and the financial position of all companies potentially affected by the tax. This was not a trivial task, involving perhaps 50 companies and multiple years of results for each, as well as balance sheet data that would allow us to look at issues of affordability, and share price data that would allow us to look at shareholder returns.

4.8 That data then had to be built into a form of spreadsheet model that would allow us to quickly examine the distribution across companies of a tax constructed on a particular basis, and the impact of that tax on the company's financial position. The spreadsheet models involved were large and complex.

4.9 The tasks specified above would have taken at least a month to complete, but were essentially delegated to the more junior staff and overseen by my project manager. I was therefore relatively free to focus on the potential design parameters for the tax.

Considerations as to rationale

4.10 At the time, I recall that there was speculation in the business press that the windfall tax could be distributed across companies pro-rata to revenue, or to market capitalisation, for example. Within the spreadsheet model that we were constructing, we would have the ability to examine the effect of given levels of tax distributed in these ways, but it was always

clear that such taxes would be unsatisfactory, for several reasons:

- First, because they would be arbitrary, and therefore unfair—in that the relative impact would be unrelated to any conceivable justification for the tax being levied. This can be understood as a practical problem, in that an arbitrary tax is, at least as we understood it, more liable to challenge.
- Second, because they would be inefficient in a static sense—in that the distribution of the tax would be unrelated to any company's ability to pay. Given that the tax needed to be consistently applied, the scale of the amounts raised would be constrained by the ability to pay of the company on which it fell the hardest.
- Third, because they would at least in some cases be inefficient in a dynamic sense. Levying an additional tax on forward profits serves only to reduce the incentives on companies to generate those profits. An efficient tax—which raises revenue with as little unintended distortion of economic behaviour as possible—would necessarily be levied on some performance parameters that were either fixed or otherwise not susceptible can only be judged to be excessive in relation to some measure of a level of profitability that would be judged to be normal.

4.11 As a general principle, the solution to the second problem (of static efficiency) is also the solution

to the first (of arbitrariness). A tax that is not arbitrary will in general be more efficient than one that is. Chris Wales and I were both clear that if we were to design a tax, it should be a good one; without, as far as possible, arbitrary effects. That meant that the way in which the tax fell on specific companies ought to be related to circumstances that gave rise to, or provided the justification for, the tax.

4.12 Prima-facie, the immediate justification for the tax was the scale of profits being made by British Gas and the then newly privatised electricity and water companies. By itself, though, this was unworkable: the class of companies that would be subject to the tax needed to be defined in more general terms, and the way in which it would be applied needed to be capable of being described in a consistent way across that class. The scale of profits also needed to be set against some benchmark—since profits can only be judged to be excessive in relation to some measure of a level of profitability that would be judged to be normal.

4.13 In particular there was some difficulty in defining a period within which any excess profits would be measured. Taxing forward profits was always going to be unsatisfactory from my perspective, for several reasons:

- First, because it would be dynamically inefficient, for reasons described above. Incentives would be distorted, and companies would take steps to reduce their profits across the period over which the tax was collected.

- Second, because of the linkage described in the preceding section between the profits made in one price control period and the price reductions to consumers in the next. If profits were unnecessarily reduced in one period, then prices would be unnecessarily high in the next. From my perspective this was economically wasteful, but I also understood it as politically undesirable for the tax to be capable of being described as being passed on to consumers.
- Third, because the independence of the economic regulators would, at least from my perspective, have been undermined. That independence was an important feature of the system, and I believed that it would have been a mistake for the Government, in effect, to impose its own view as to the appropriate level of profitability over that of the regulators.

4.14 For similar but not identical reasons, the second and third of these points would have held good, I believed, even for a retrospectively applied tax if the period that was covered included a period in which the companies' prices had been set by their economic regulators. The Government would still, in effect, have been imposing its own view over that of the regulators; and future incentives to achieve greater efficiency could still be compromised if the perception were that similar taxes might be imposed in future.

4.15 In each of the privatised utility companies, however, the prices established for the *initial period after privatisation* had not been set directly by the relevant regulators. As I have

noted in Section 3 above, companies were in general privatised with a given level and trajectory of prices to apply over a given period of time. For each privatised industry there was also a regulatory function established prior to privatisation, but the regulator did not set the prices, even if he or she was consulted as to the appropriate price trajectory.

4.16 Conditions were therefore different in the initial price control period after privatisation, and the circumstances were such as to allow the newly privatised monopoly companies the chance to earn significantly increased profits during that time. This was the justification for the tax that Chris Wales and I settled on relatively early on—I believe during July of 1996.

Considerations as to design

4.17 The premise for the tax was therefore related to profits made in the first price control period. After that time, there was a regulatory system that took over; and outperformance was a necessary and important feature of that system. For any profits to be assessed as excessive, however, there needs to be some benchmark as to what is normal. Establishing that benchmark presented some particular difficulties.

4.18 Many excess profits taxes have taken as a benchmark a percentage rate applied to the book value of the company's assets. For example:

- The UK taxes imposed during the First and Second World Wars were based in part on

profits in excess of 6% and 8% respectively of capital employed on a historic cost basis;

- The US taxes imposed during the First and Second World Wars were also based on pre-war profit levels but constrained by a band of 7-9% of invested capital; and
- Similar structures have been used from time to time in other countries, most notably in the 1990's in Scandanavia.

4.19 The premise upon which this approach is based is that the book value of the assets is a proxy for the costs that a new entrant to the industry would have to incur in order to enter. In a normal contested market in which this premise holds good (and it often will) economists define a *normal* rate of return as one by which the company earns its cost of capital; and rates in excess of that as being *supernormal.* In the taxes listed above, the percentage rate applied is therefore intended to represent the companies' cost of capital.

4.20 For the regulated monopoly utilities, however, the book value of assets had in many cases been explicitly abandoned as a component of the price setting process; more normally it was the market value at flotation—adjusted for subsequent investment—that was incorporated. This came to be known as the *regulatory asset base* and was in many (but not all) cases, significantly below the replacement value of the assets themselves. For example:

- In the water industry, replacement values were estimated at some 20 times the flotation values;
- In respect of British Gas, replacement values were estimated to be in excess of twice the flotation value; and
- In the case of the regional electricity companies, replacement values were estimated to be in excess of 1.5 times flotation values[12].

4.21 For similar reasons, any benchmark that we used would likewise have to be based on a figure derived from market values at flotation. This was problematic, since unlike the book value of assets, the regulatory asset base was not regularly reported—being instead calculated at each price control period (generally every five years).

4.22 The appropriate rate of return—in percentage terms—was also not a number that could easily be defined with any precision. By 1996, the setting of price controls for the regulated monopoly utilities had become a significant business, with much effort devoted by consultants (including myself) to the assessment of appropriate rates of return, and appropriate asset bases to which they might be applied.

4.23 Being personally familiar with the amount of effort applied in each case, I was reluctant to

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[12] See for example *Privatisation of Utilities and the Asset Value Problem*, August 2001 (revised December 2001), Paul A Grout, Andrew Jenkins and Ania Zalewska.

contemplate the use of broad brush parameters across different industries and equally reluctant to establish rules by which those parameters might be varied from one industry to another for the purposes of setting a tax. I felt that even framing a tax in such terms would mean that the entire academic and consulting community working in this area would feel obliged to comment adversely (since it was their clients, or companies that they would like to have as clients, who would be adversely affected), and that this would provide a foundation for criticism that might easily endure.

4.24 Chris Wales was also uncomfortable with framing a tax in such terms, although his reasons, as I recall, were linked to the lack of available market benchmarks by which the rates could be judged. He felt, and I agreed, that the tax would be far more likely to be unchallenged if the initial press opinion was positive, and that that was in turn far more likely if the underlying figures on which the tax was based were intuitively comparable to market data from the perspective of a business journalist.

Design parameters

4.25 The solution that we identified was in effect an alternative expression of the basic rationale for the tax (the excess profits made in the period immediately subsequent to privatisation). It is obvious in retrospect, but at the time the focus on profits meant that it was easy to forget that profits can only be judged to be *excessive* in

relation to something; and in our case, for reasons explained above, that was the flotation value.

4.26 So in framing the justification for the tax, one might say:

> "*The profits earned by the privatised monopoly utilities in the period after privatisation were high in relation to those companies' flotation values*".

But one might equally say:

> "*The flotation values of the privatised monopoly utilities were low in relation to the profits subsequently earned by those companies.*"

4.27 A similar re-framing is not possible in a conventional windfall profits tax, because although one can say that profits are too high in relation to the level of assets deployed, one cannot meaningfully say that the level of assets deployed is too low.

4.28 As I recall, the idea to express the rationale for the tax in the second of the two ways set out above was first raised in a meeting between Chris Wales and me. I recall that I was immediately attracted to the approach, because it allowed the benchmark to be expressed in more conventional price/earnings terms (rather than in terms of a cost of capital, or an allowed rate of return).

4.29 I do not recall precisely when this happened, but it must have been in July of 1996. By November,

we had validated the yields available from the tax at different multiples and tested for impacts on solvency and investment. Both of these required us to project the position of each of the companies as at the point that the tax would actually be paid, and therefore involved reasonably complex modelling at the individual company level.

4.30 There were some exceptional circumstances that needed to be considered. National Grid, for example, was regulated but had not been subject to its own flotation, since it had been owned (but had subsequently been sold) by the RECs. Since the dividends that had been paid by National Grid had been treated as income in the accounts of the RECs, and therefore were included in the calculation of the RECs' tax liability, we felt that there was no need to be concerned about the exclusion of the company itself.

4.31 British Gas had recently demerged into BG (which essentially owned the pipeline assets) and Centrica (which essentially inherited the customer relationships). It was therefore necessary to apportion the tax liability between the two companies. This was done, pragmatically, on the basis of each company's market capitalisation at the point of demerger.

4.32 There was also a question of partial flotations. In these cases (particularly BT, and the electricity generators) the approach was also pragmatic. We took the view that the profits that the companies had made in the initial periods post privatisation could only sensibly be

judged to be excessive against the proportions of the companies that had initially been privatised. It made sense, therefore, to scale down the tax liability accordingly. Since the companies involved had been subject to independent regulation at the point of subsequent tranches of shares being sold, the overall logic of the tax suggested that no tax liability ought to arise in respect of those tranches.

4.33 Finally, there was the question of those companies most recently privatised, for which the initial period would not yet have elapsed. For reasons explained above, we did not believe that it would be desirable to impose a tax on *future* earnings. Yet the companies would, at least in principle, have the same opportunity for outperformance in the initial period. On that basis there was no reason to adjust the basic approach adopted elsewhere, even if the implication was that the effective tax burden on profits realised up to the relevant date was thereby increased.

4.34 These issues were worked through during the late summer and early autumn of 1996. During the same period we sought and obtained legal advice on the susceptibility of the tax to challenge, and obtained informal input from certain regulators as to the potential for the tax to impact on prices. As I recall, these were the regulators with whom I was working at the time. In November we presented the suggested approach to Gordon Brown. It may be helpful to

note a couple of points in relation to that presentation.

4.35 First, the presentation starts with a repeat of the scope of work, and proceeds with some caveats. As before, the purpose of doing this was not really to inform the meeting, or to communicate any concerns. Rather, the purpose was to ensure that we would, should it ever become necessary, be able to say that we had communicated such concerns.

4.36 Second, the design of the tax by then had been stable for some time, and as may be evident from the presentation, we had completed a lot of analysis on its parameters and potential impact. The intent of the meeting was therefore that we would simply get sign-off from Gordon Brown to continue. It was not in any sense a *working* meeting.

4.37 There is in the presentation a brief review of potential alternative designs. Although we had by then analysed the impact of some of these, we had never seriously contemplated recommending them. The reason for including them in the presentation was therefore not to promote discussion of them, but rather to *prevent* discussion of them. We did not want a situation to arise in which Gordon Brown asked *"but what about..?"* in relation to an alternative, because it might have taken the meeting off track.

4.38 In the event, the meeting progressed as planned. Chris Wales and I talked through the material,

and Gordon Brown indicated that he was happy with the direction we were taking. I do not recall that he asked any questions at all.

4.39 My involvement in the project was much more limited after 1996, although my team did further work on examining the nature of the draft legislation that would be required, and to update the analyses as further accounting information became available. Chris Wales was much more closely involved with the project in 1997, and subsequently joined Gordon Brown's team at the Treasury following the Labour Party's success in the May 1997 elections.

4.40 I believe that the Treasury had some alternative proposed approaches to the windfall tax, but after some debate it was our design that was adopted. I believe that the legislation reflects the same principles—subject only to some adjustments to the number of years over which profits were to be averaged (four rather than five); the multiple to be applied (on which we had not taken a view, assuming that it would be the parameter to be flexed to provide a given yield); and the tax rate (23% rather than the 33% we had assumed).

Conclusions

4.41 The question that I have been asked to address in preparing this report is whether the design of the windfall tax enacted in the UK in 1997 was designed to tax excess profits or whether it was in some sense a tax on value. As I have noted above, the basic rationale for the tax was

undoubtedly the level of profits earned by the companies.

4.42 More particularly, the rationale for the tax that we adopted was the level of profits earned by the companies in the period immediately subsequent to flotation. As I have explained above, however, the nature of the UK's regulatory system is such that profits can only sensibly be benchmarked against a regulatory asset base derived initially from the companies' flotation values.

4.43 This in turn means that there is a logical symmetry between the two available ways of describing the rationale for the tax—that profits were high in relation to the flotation value, or that the flotation value was low in relation to profits. There were important presentational reasons for choosing the latter; but they were from my perspective essentially presentational: there is no sense in which the intent of the tax was to assess a better value for the companies than that provided by their flotation. With respect to the electricity sector, for example, I believed, and still believe, that the scale of the efficiency gains that drove the level of profits immediately after privatisation was wholly unforeseen.

4.44 The *value in profit making terms* described in the wording of the tax itself is therefore not a real value, and neither is its calculation a real valuation, since it is based on ex-post realised profits that were not anticipated as at the date to which it is applied. No valuer could or would

argue that the companies were *in fact* worth that amount as at the date of privatisation. For similar reasons tax authorities would not, at least in the jurisdictions with which I am familiar, normally contemplate the use of a hindsight-based valuation driven solely by ex-post realised earnings.

4.45 Even on a hindsight basis, no valuer could properly assess a value for a UK regulated company on the basis of a multiple applied to average earnings during a single price control period. The P/E multiple of 9 in particular requires an expectation that profits will continue at a similar level for significantly more than the 5 year period covered by the first price control period. The effect of the UK regulatory framework, however, is to bring prices, and therefore profits, back in line with a regulatory value at the start of the next price control period.

4.46 For all of the above reasons, although the tax was expressed in *the language of value*, it was expressed in that way essentially for presentational reasons. While that presentation proved to be effective in political terms, it requires an underlying concept of value (based on actual ex-post earnings) that would be alien to any valuer.

4.47 There is, in conclusion, no doubt in my mind that the *character* of the tax that Chris Wales and I designed was that it was taxing excess profits: that was in reality what we were asked to do and it is what we did.

5. Declarations

5.1 I confirm that I fully understand my overriding duty to the Court and that I must help the Court on matters within my expertise. I believe that I have complied with this duty.

5.2 I confirm that insofar as the facts stated in my report are within my own knowledge I have made clear which they are and I believe them to be true, and that the opinions I have expressed represent my true and complete professional opinion.

Chris Osborne
8 September 2008
LECG Limited
Davidson Building
5 Southampton Street
London WC2E 7HA

[Appendices omitted in printing this appendix]

EXHIBIT 140-P

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Report of Christopher John Wales
On Behalf of PPL Corporation and Subsidiaries

September 8, 2008

[Table of Contents omitted in printing this appendix]

The UK Government's 1997 windfall tax

1. Introduction and summary of key point

This report provides both a narrative history of the design of the UK government's 1997 Windfall Tax and an analysis of the issues that were considered by the design team in which I played a significant role. It sets out my educational background and history

and in doing so provides some context for my involvement in the original project and in this case.

The report comprises five sections. This section, Section 1, provides a brief introduction and a summary of key points. Section 2 sets out my biographical background, including my educational history and career up to and beyond my involvement in the Windfall Tax project. It establishes my credentials as a tax policy-maker and commentator on policy. Section 3 provides some political context for the Labour Party's commitment to a windfall tax and the evolution of the idea within the party leadership. Section 4 deals with the Windfall Tax project itself. Section 5 concludes.

The report is based on my best recollection. In some places it is at variance, at least as regards the dates on which events took place, with published material, including the account of these events by Geoffrey Robinson MP in his book, "*The Unconventional Minister*". I have based my narrative account of events on an appointments diary for 1996, which fits with the progression of the work that I recall and the logic of the project as it unfolded. However, the precise timing is probably not critical to the case at issue.

I do not purport to be an expert on US taxation and I do not offer an expert opinion as to whether the Windfall Tax is a creditable tax in the US for the purposes of the UK-US Double Taxation Convention or meets the relevant tests in IRC Section 901. However, I am in a position to offer some information and explanations about the structure and design of

the Windfall Tax that may be helpful to the Court in its deliberations.

I believe that the key points for the Court to note can be summarised as follows:

- The Andersen team was instructed to design a tax on the excess profits of the privatised utilities and we sought to do that in a way that would bring principle, rhetoric and all the underlying political and economic rationale for the tax together.
- We rejected a number of possible mechanisms for the tax, some of which responded more directly than the final design to one or other aspect of the underlying rationale for the tax. We did so because of serious technical, presentational or political issues which meant that we could not recommend them to the Labour leadership.
- We devised a mechanism for taxing those excess profits that had presentational benefits because:
    i. it based the tax on the excess profits that each of the taxpayer companies had earned in the years immediately following their privatisation, when regulation was most benign;
    ii. it used a range of publicly available market reference points, which improved transparency, to strengthen its legitimacy;

iii. it created a linkage between the tax and the popular view that the utility companies were sold off too cheaply;

iv. it was substantially similar to existing legislation that had been specifically disapplied in relation to most of the privatisations; and

v. it led to a distribution of the tax burden among the utility companies that we believed would be accepted as broadly fair and, on the basis of its final scale, was well within the means of all of the companies affected.

The importance of the influence of politics and presentation on the design of the Windfall Tax proposal should not be underestimated.

- The Labour leadership, members of the House of Commons and commentators at the time regarded the tax as a tax on the excess profits of the privatised utilities.
- We did not specifically aim to create a tax that would or would not be creditable for the purposes of the tax systems of the US or any other jurisdiction but we were aware that, because of both the substance and the form of the tax, it might be considered creditable under US rules. For our purposes, the main question was whether the imposition of the tax might give rise to a challenge under EC law on the basis that it was creditable in one jurisdiction but not another and, therefore, discriminated against certain shareholders.

2. Biographical background

I begin with some details of my past. My biographical background up to the point of the commencement of the Windfall Tax project is presented in the first three sections: my education, my early career, and my involvement with the Labour Party and taxation policy issues; and in the fourth section I set out details of my career after the Windfall Tax project had been completed. A detailed *curriculum vitae* is attached as an appendix to this report.

2.1 Education

In this section, I set out my basic educational qualifications.

I was born in Goole, Yorkshire, on 13 October 1953 but most of my early life, from age 3, was spent in Lincolnshire. I grew up in the village of Wainfleet St Mary and was educated nearby at Skegness Grammar School.

In my final two years, I studied Latin, French and History, obtaining the highest grades in all three subjects in both Advanced and Special papers in the summer of 1971. I was awarded the prize for the best A level results in my school in that year. I was placed 6th in the national list of students in Special Level Latin.

In October 1971, I took up a place at Selwyn College, Cambridge to study History as an undergraduate. Selwyn College is part of the University of Cambridge. I studied there for 3 years and graduated in 1974.

In October 1974, I began a one year postgraduate course at Cambridge University, the Postgraduate Certification in Education (PGCE) which is normally a precursor to a career in education. I qualified in the summer of 1975 with a distinction in educational theory.

In 1975, I was accepted as a research student at Selwyn College, Cambridge to undertake research at the History Faculty into the consequences arising from the system of land tenure in the Danelaw in the twelfth century. The Danelaw was a geographical region in central and eastern England with some distinctive legal features. I completed my research in the summer of 1979 and left full-time education. I wrote up my thesis on a part-time basis from September 1979 and submitted it for examination in December 1983. The thesis was entitled "*The knight in twelfth century Lincolnshire*". In 1984, I was awarded a PhD by Cambridge University for that work.

2.2 Early Career

In this section, I provide details of my early career up to the point at which I became involved in the design of the Windfall Tax.

In September 1979, I joined the London office of Arthur Andersen as a trainee accountant in the tax practice. I took the accountancy examinations for the Institute of Chartered Accountants (England and Wales) and passed all of the examinations at each stage, qualifying as a Chartered Accountant in 1982. I progressed through a fast-track career process and

became a full international Partner in Arthur Andersen in 1990.

Throughout my career at Arthur Andersen, I worked in the tax practice. I spent the period 1979-1991 in the London office of the firm. In 1991, I transferred to the Stockholm office as head of the international tax practice in Sweden, returning to the London office on a fulltime basis in the summer of 1995 where I remained until the end of August 1997.

During the early part of my career, my training and client work at Arthur Andersen covered almost all aspects of taxation: personal, corporate, direct and indirect. The firm was relatively small in the UK at that time and, like the other major accounting firms, its tax practice did not then have the degree of specialisation that is now characteristic of most large firm practices. This was changing by the time I became a Manager in 1984. From that time onwards, I had a strong international element in my work. I also began to do more work for investment banking clients where the emphasis was on cross-border issues, including corporate re-organisations and financial instruments; and I became increasingly interested in tax policy issues.

When I moved to Stockholm, I took on responsibility for co-ordinating the firm's relationships with the Swedish multinationals. At that time, Sweden had more multinationals per head of the population than any other country and Arthur Andersen's relationship with them had been perceived to be weak. My role was to strengthen the firm's presence and its relationships and to generate project work for both the Swedish and the global tax practice.

I returned full-time to the London office in the summer of 1995 and resumed my career there with a mix of international and financial sector clients. During that period, I was also given responsibility for the UK firm's work with the European Commission and for the development of work on EU issues.

2.3 Involvement with the Labour Party and taxation policy issues

This section summarises my involvement with the Labour Party between 1979 and the start of the Windfall Tax project. It covers both my involvement in the local Labour Party and with the Party leadership on taxation policy issues.

In parallel with my career at Arthur Andersen, I became an active member of the Labour Party and closely involved in policy issues.

I joined the Labour Party in September 1979 and became involved almost immediately with what was then my local Constituency Labour Party in Watford (Hertfordshire). I held various local party offices, including Treasurer and ultimately Chairman. I stood as a Labour Party candidate for the position of Councillor on Watford Borough Council in 1982 and was elected for a 4-year period. I remain a member of the Labour Party.

In 1983/4, I met Tony Blair who was, at that time, a relatively new Member of Parliament and was one of the Labour Party spokesmen on Treasury issues. Labour was then in Opposition. The Conservative Party was in Government, a position which endured until 1997. I began to work with Tony Blair and the rest of the Labour Shadow Treasury team on

taxation policy in my "spare time". This included drafting amendments to conservative Finance Bills in the mid-1980s.

I assisted a number of Labour Party Treasury spokesmen, including John Smith, later a leader of the Labour Party, on tax policy issues between the mid-1980s and 1991, when I left the UK to work in Sweden. During my period in Sweden, I met a number of opposition Social Democrat members of the Swedish Parliament (including the later Prime Minister Gōran Persson) and produced a substantial paper for them on some tax policy issues. While in Sweden, I was less involved in UK Labour Party issues for a time but this changed when I was asked by Andrew Smith MP, later a Cabinet Minister in the Blair Government, to assist on the tax and accounting issues related to the programme of rail privatisation implemented by the Conservative government in the early 1990s. I did some work on those issues from my Stockholm base.

On my return to the UK, I was asked by Gordon Brown MP, then Shadow Chancellor, to join his opposition Treasury team to work on tax strategy in the run-up to what became the 1997 General Election. However, Arthur Andersen declined to release me for that work.

My involvement with the Labour Party and my close links to some of its leadership were well-known at Arthur Andersen. I had been instrumental in arranging for Tony Blair to speak to a senior Arthur Andersen audience and had also been involved in internal meetings focused on the implications for the firm of a Labour government. Stephen Hailey, a

member of the Arthur Andersen Board who was also a member of the Labour Party, involved me in a number of such meetings.

It was Stephen Hailey who asked me if I would be willing to take responsibility for the Windfall Tax project and who introduced me to Chris Osborne, then a partner in the firm's Economic and Financial Consulting practice, who subsequently worked with me on the project.

2.4 Life after the Windfall Tax

This section details my involvement in tax policy issues after the Windfall Tax project and provides further information on my career from 1996 to the present.

Following completion of the work on the design of the Windfall Tax, I was asked by the Labour team, Gordon Brown (now Prime Minister), Ed Balls (at one time a Treasury Adviser and now a Cabinet Minister) and Geoffrey Robinson (at one time a Treasury Minister) to develop a broad range of tax policy proposals in the run-up to the General Election. Over the next few months, I worked with them to produce major reform proposals that covered corporate and business taxation, the taxation of capital gains and a number of personal tax issues. On 2 May 1997, the day after the Labour Party's landslide election victory, these proposals were handed over to Treasury officials and became a blueprint for the tax changes introduced in the first few Budgets of the new Labour Government.

During the summer of 1997, I was asked to become a founding member of the Council of Economic

Advisers that Gordon Brown was setting up at HM Treasury. This was to be modelled on the US Council of Economic Advisers and would, in due course, recruit policy experts to cover key areas of policy development. I agreed to join with effect from the end of August, which was the end of Arthur Andersen's financial year, and to take responsibility for tax policy development. I took up my post in September 1997 and continued as a member of the Council of Economic Advisers and Gordon Brown's principal adviser on taxation policy until I left the Treasury at the end of November 2003.

In that role, I was responsible for managing the development and implementation of much of the present Government's taxation strategy and reform agenda to support the Chancellor's broad economic policy objectives.

The main aspects of my role were:

- responsibility for tax policy, from origination to delivery
- leading the development of policy proposals with the appropriate revenue departments
- managing and leading the process of external consultation on policy proposals
- overseeing the detailed implementation of proposals through the Budget and Finance Bill process

I managed the interface between the revenue departments and the ministers. It was my responsibility to ensure that official advice to Treasury ministers on taxation matters was

appropriate in the context of the Government's economic policy objectives and that the underlying analysis was sound.

I was responsible for the presentation of the government's tax reforms to the business community. I regularly met senior executives from the UK's leading companies on a one-to-one basis in order to discuss priorities and to sharpen the focus of the Government's reform programme. I spoke at many "Business Leaders" dinners, seminars and other events to explain Government proposals and to answer questions. I also spoke outside the UK on Government policy issues.

I was closely involved in the development of the Government's international tax agenda. This included a significant role in discussions with ministers and senior officials at Finance Ministries in and beyond the EU. I was heavily involved in the process of negotiating the EU "Tax Package" which consisted of three inter-linked proposals on direct taxation. I attended formal meetings of EU Finance Ministers with the Chancellor when the agenda required it. I also took part in negotiations with the UK Dependent Territories.

I led the work of the EU *Code of Conduct Group (Business taxation)* on behalf of its Chair, the Paymaster General, Dawn Primarolo, from 1998 to 2003. This was a parallel process to the OECD work on "harmful tax practices" aimed at discouraging the use of preferential tax measures that "are anti-competitive and undermine fair competition and public confidence in tax systems" (www.oecd.org). The role involved extensive contact with ministers

and officials from other Member States, with EU Commissioners and Commission officials and with the European Council Secretariat. I chaired meetings with them on behalf of the Paymaster General whenever necessary.

I attended ministerial level meetings in the US at the White House, the US Treasury and with members of the US Council of Economic Advisers. I also worked with the Head of the Fiscal Affairs section of the OECD.

When I left HM Treasury, I was invited to become a Visiting Fellow at the Centre for Tax Law at the Faculty of Law at Cambridge University and to take on some teaching responsibility there. I accepted this offer and during my time in Cambridge I carried out a substantial piece of tax policy work on behalf of the government of another European Union member state. I remained at Cambridge until I was permitted by the Cabinet Office of the UK Government to take up an offer from Goldman Sachs to join their London office as a Managing Director in March 2004. My work at Goldman Sachs involved a range of projects that included financing opportunities for European governments and taxation structures for European multinational companies.

During 2004-5, I personally led an initiative to set up an independent academic research centre on business taxation, which has now become the *Oxford University Centre for Business Taxation*. The UK had not previously had a research centre of this type. To set up the Centre, I secured 5 years' funding for the research programme with contributions from more than 60 of the UK's 100 largest listed companies. I

am now a member of the Advisory Board and have chaired and spoken at seminars run by the Centre. The *Oxford University Centre for Business Taxation* is now one of the largest research centres at the Saïd Business School and has been awarded substantial additional funding from public sources. It has produced a wide range of research on taxation issues and holds regular seminars attended by members of the academic community, by senior policy makers in the UK government and by representatives of the companies that fund it. It is engaged in funded research on behalf of the European Commission and has close links with academics and policy makers in many countries.

I left Goldman Sachs at the end of 2005. In January 2006 I returned to Cambridge University, again as a Visiting Fellow, to complete some work on tax policy that had been requested by Gordon Brown. Having completed that work, in March 2006 I took up an offer to set up a new insurance company with two former colleagues from Arthur Andersen. I am now Managing Director of that company, Lucida plc. It is an authorised insurance company specialising in longevity risk business.

I have continued to work and write on tax policy issues. I have written several articles that have been published either in the national press or in taxation journals in the UK and have spoken at or chaired seminars and conferences on taxation policy issues. I have recently written a commentary on a chapter of the Mirrlees Review. This is a major review of UK taxation policy, led by Professor Sir James Mirrlees, carried out under the auspices of the UK *Institute for*

Fiscal Studies, to which most of the best-known global experts on taxation policy have made a contribution. My commentary will be published as part of the Mirrlees Review. I am a member of the Council of the *Institute for Fiscal Studies*. I have been working with a well-known Westminster-based think-tank, the *Smith Institute*, on a series of seminars on taxation policy and both edited and contributed to a monograph that was published in connection with that series. I am in contact with the UK Government on tax policy issues and am called upon from time to time by the Prime Minister's office to provide input. I have also been asked to work with the Government of Jersey, one of the UK's Channel Islands, on tax policy matters.

My involvement in the case of *PPL Corporation and Subsidiaries vs. Commissioner of Internal Revenue* dates from the autumn of 2007. I was contacted by Chris Osborne of LECG who asked me if I would be willing to meet representatives of Hunton & Williams to talk about the 1997 Windfall Tax. As a consequence of our initial meeting I was asked, for the purposes of this case, to describe the background to the tax, to summarise my involvement in its design and to set out my thinking about some of its key features.

3. Political background

In this section, I provide a short summary of the political background to what became the proposal for a Windfall Tax on the excess profits of the privatised utilities.

The proposal to levy a windfall tax has to be understood against a background of evolving policy within the Labour Party.

Throughout the 1980s, the membership of the Party, at grass roots level, was implacably opposed to the privatisation of publicly owned assets. One of the fundamental tenets of Labour Party philosophy was a belief in common ownership of the means of production. It was enshrined in Clause IV of the Labour Party constitution and the text was printed on every party membership card:

"*To secure for the workers by hand or by brain the full fruits of their industry and the most equitable distribution thereof that may be possible upon the basis of the common ownership of the means of production, distribution and exchange, and the best obtainable system of popular administration and control of each industry or service.*"

Members were actively discouraged from subscribing for shares when Government-owned businesses were floated and, among those who chose to participate, many did so only to donate their profits to charity or to the Labour Party itself. However, over time, the political success of the Conservative Party in achieving popular approval for the concept of privatisation, the sheer scale of the privatisation process and the breadth of eventual public participation in it as shareholders gradually made it imppssible, politically, for the Labour Party leadership to espouse a policy of complete renationalisation, whatever the strength of feeling among its core membership.

Over the course of successive Conservative administrations, Labour policy therefore evolved from a strong leaning towards renationalisation to what became the proposal for a one-off tax on the privatised utilities. This evolution can be traced through a series of public comments and speeches reported in the press of the day, extracts from which are set out below.

The process started with the first two major Conservative privatisations undertaken in their second term of Government, namely British Telecommunications plc (BT) and British Gas plc (BG). Both were strongly opposed by the Labour leadership. In 1984, Labour said that they would renationalise all state businesses privatised by the Conservatives and specifically committed themselves to bringing BT back into public ownership. The 1984 Labour Party conference in Blackpool was told that privatisation "*disrupted the development of key sectors, threatened supplier industries and was a disaster for the consumer*", and that it placed public assets in "*the grubby hands of privateers*". There were calls for renationalisation to take place without compensation but these were rejected by the leadership of the day. Roy Hattersley, then Deputy leader of the Labour Party, said that renationalisation would take place on the basis of "*no speculative gain*". (*Financial Times*, 5 October 1984)

The 1986 Labour Party conference approved plans to restore BG as well as BT to public ownership. David Blunkett, later a Cabinet Minister in the Blair Government, commented at the time that, if privatised, the water industry should be

renationalised without compensation. *(Financial Times,* 3 October 1986)

However, as time went on, there was more ambivalence in the Labour leadership's approach. On 7 May 1989, the *Times* reported that "... *a commitment to renationalise the water industry*" was added at a late stage to the outcome of Labour's mid-term policy review, but this decision was reported to be "... *on environmental rather than ideological grounds*".

On 27 March 1990, in the run up to electricity privatisation, the *Financial Times* carried a report that Labour MP and then energy spokesman Frank Dobson had reiterated that the Labour Party had "... *no commitment* to *renationalise the electricity industry*", but did intend to tighten regulation.

On 15 July 1990 the *Independent* reported that, under prevailing Labour policy "... *Only British Telecom, the national grid and the water companies are listed for return to the public sector when possible and then at the prevailing share price. This implies that Labour would not seek* to *renationalise British Gas or the power generators ...*"

The *Times* ran a story about Labour party policy on 12 December 1990, reporting that the privatisation of the electricity industry had been condemned by Neil Kinnock, the Labour Party Leader as "... *a scandal and a great swindle ...*"

On 4 January 1992 it was reported in the *Guardian* that "*Labour has shelved its commitment to take back a controlling stake in British Telecom ...*" and that "... *plans* to *renationalise the water industry have also*

been deferred". later that month, the Labour Party was reported to be "*considering a scheme to use government shares in National Power and PowerGen, Britain's two big generating companies, as a bargaining point to restore state control over the National Grid Company ...*" and that "*a share swap with the regional supply companies, which own the grid company, could enable Labour to renationalise the grid without spending a penny of taxpayers' money*". *(Times,* 6 January 1992)

On 22 February 1992 the Labour Party was reported by the *Times* as having "*... toned down its renationalisation plans since the* 1987 *election*". The report also stated that the party's "*... present priorities [were] to take the ten regional water companies back into public ownership and to renationalise the national grid.*" A spokesman for Gordon Brown, then shadow trade secretary, said it was Labour policy that if the privatised companies made excessive profits they should be reduced to a more normal level in industry.

The evolution of Labour Party policy during this period was taking place against a backdrop of growing public concern about the privatised utilities. Public discontent with the perceived high profits accruing to the regulated industries was significant and reported widely over a long period. National newspapers reported, for example:

"*... BT is discovering to its cost that excess profit arising from monopoly power is more easily tolerated when the fruits go back into the public purse.*" *(Guardian,* 17 October 1985)

"... *political outcry over high profits and salaries in the privotised utilities.*" *(Independent*, 1 June 1991)

"... *water companies in England and Wales face mounting criticism for high profits, poor service, and inflated boardroom salaries.*" *(Guardian*, 18 June 1992)

"... *Nearly all the backlog of capital spending on the core business of the 12 distribution companies, conveying power to people's homes, has been completed, excepting one-offs such as repairing storm damage. Yet the profit increases to be announced over the next month are staggering, certain to cause political ructions ...*". *(Times*, 9 June 1992)

Even today, the papers still vividly recall the public hostility to post-privatisation executive pay in the former public utilities. Jonathan Guthrie, writing in the *Financial Times*, sums up the public mood in his article of 28 February 2007:

"*In 1995, opposition to soaring pay for bosses at privatised utilities coalesced around the portly figure of Cedric the Pig. Cedric waddled out at the behest of the GMB union to illustrate its contention that directors of British Gas, led by Cedric Brown, had their snouts in the trough.*

Cedric the Pig had little interest in fame. He retired to live peacefully on Mudchute Farm in the East End, only leaving for occasional reunions with fellow unionists. Unlike his human namesake, he was never knighted.

But ever after, images have appeared sporadically in the media of the porcine protester scarfing swill

outside BG's annual meeting. Cedric the Pig entered the collective unconscious as shorthand for managers on the make. His 15 minutes of fame marked a point at which many Britons decided privatisations had gone far enough. If Sir Cedric is remembered at all by the public, it is as "the pig guy"."

So, well before the 1997 General Election, there was clear evidence that the Labour Party had popular support for taking a tough line with the privatised utilities. The issue for Labour's leadership was how to best channel that public support in developing policy.

I believe that the first references to the possibility that an incoming Labour Government might include a windfall tax on the profits of privatised utilities as part of its policy programme were reported in the press in late 1992. The *Daily Mail* noted on 10 November 1992, that in order to fund public sector pay rises and capital projects to create jobs for construction workers, Gordon Brown was considering a Windfall Tax: "'*He won't utter a word to offend the public sector unions.*" said the report. "*Instead, he retreats into the easy populism of suggesting a 'windfall' tax on the profits of privatised utilities such as gas and electricity.*"

The previous month, the *Financial Times* had revealed that the idea of such a tax was already being discussed by the trade unions. On 17 October 1992 it had reported that two of the largest trade unions in Britain, the TGWU and GMB, had pledged their support to the Windfall Tax, saying that money was needed to prevent job losses arising from potential pit closures and to provide a stimulus to the

economy. The union view was that "... *some of the £10bn could be raised through a one-off 'windfall' tax on the profits of the privatised utilities*".

Over the next few years, the "modernisation" of the Labour Party was gaining momentum. By 1995, the shift towards the political centre ground under Tony Blair was quite clear. At the 1995 Party Conference, he pushed through a significant and symbolic revision to Clause IV, taking away the overt commitment to common ownership and putting in its place a rather different set of principles. The new Clause IV read:

"*The Labour Party is a democratic socialist party. It believes that by the strength of our common endeavour we achieve more than we achieve alone, so as to create for each of us the means to realise our true potential and for all of us a community in which power, wealth and opportunity are in the hands of the many, not the few, where the rights we enjoy reflect the duties we owe, and where we live together, freely, in a spirit of solidarity, tolerance and respect.*"

With that shift, the leadership signalled, *inter alia*, its intention not to engage in a major programme of re-nationalisation. For the utility sector, the consequence was that it pushed the party more firmly towards an alternative strategy based on taxing the excessive post-privatisation profits.

On 4 July 1996, Tony Blair committed the party formally to the Windfall Tax with the launch of the draft manifesto that included among its five specific pledges a commitment to "*Take 250,000 young people off benefits and into work by using money from a*

"Windfall tax" on privatised utilities". By November 1996, the policy was sufficiently well-established to be written about in the following terms by George Jones, Political Editor at the *Daily Telegraph*. Noting that:

The party's draft manifesto ... said it would be a "one-off windfall levy on the excess profits of the privatised utilities", he wrote:

Labour aims to raise more than £5 billion from a windfall tax on the profits of the privatised utilities, the party said last night, after a leaked City report indicated that most companies could comfortably afford a levy of that size.

Up to 30 companies with an estimated eight million individual sharehalders could now be hit by the proposed tax, which would form the cornerstone of a first Labour Budget...

Mr. Brown said that the case for the one-off tax on the "excess" profits made by the utilities during privatisation was now unarguable. He said: "This report shows that we have been absolutely right in arguing for a windfall tax because of the huge excess profits the utilities have made at the public expense." (*Daily Telegraph*, 8 November 1996)

The policy was re-affirmed in Labour's formal manifesto, published in the run up to the General Election that took place on 1 May 1997. The manifesto committed the incoming Labour Government to introducing a budget "... *to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work*

programme will be funded by a windfall levy on the excess profits of the privatised utilities ...". The Windfall Tax aimed to fund the Government's Labour market policy with minimal distortion of the economy.

During the election campaign, on 7 April 1997, Tony Blair, appearing on the BBC's Panorama programme, said "*We will have the Windfall levy on the excess profits of the privatised utilities. That will allow us to put in place a programme to get the long-term and young unemployed back into the workplace.*"

When Gordon Brown addressed the House of Commons on 2 July 1997, making his first Budget speech as Chancellor of the Exchequer, he made it clear that the Labour Government would honour that commitment. In his early remarks, he referred to "*that programme*" *which* "*will be the main item funded from the windfall tax on the excess profits of the privatised utilities*". (Column 309, *Hansard Commons*, 2 July 1997)

In dealing with the detail, he said: "*Our reform of the welfare state—with the programme to move the unemployed from welfare to work—is funded by a new and one-off Windfall tax on the excess profits of the privatised utilities. The tax will apply to companies privatised by flotation and subject to economic regulation under specified Acts of Parliament.*"

He also added what had become, from a presentational standpoint, an important aspect of the proposal, to link the measure to the popular view among Labour supporters that the utility companies

had been sold off too cheaply: "*In determining the details of the tax, I believe that I have struck a fair balance between recognising the position of the utilities today and their undervaluation and under-regulation at the time of privatisation. The Windfall tax will be related to the excessively high profits made under the initial regime.*

A company's tax bill will be based on the difference between the value that was placed on it at privatisation and a more realistic market valuation based on its after-tax profits for up to the first four full accounting years following privatisation." (Column 313, *Hansard Commons*, 2 July 1997). It was politically irrelevant that the National Audit Office had made it clear that the companies had not been privatised too cheaply.

This duality of presentation is also seen in the later debates on the Finance Bill. As I will describe in more detail in the next section of this report, the mechanical device for the tax had sought to link in both strands (excess profits because of lax regulation and undervalue on flotation) in order to strengthen the case for it in the popular mind. Even on a generous analysis, the two concepts can be seen to be mutually exclusive but, politically and presentationally, they represented twin pillars in the argument.

When Geoffrey Robinson, then Paymaster General (a ministerial position in HM Treasury), made his opening remarks, introducing the debate in the House of Commons on the Windfall Tax legislation, he reflected that duality in the following words: "*Clause 1 heads a group of provisions that together*

introduce the windfall tax, thus meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities. Those companies were sold too cheaply, so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatisation was too lax, so the customer got a bad deal. As a result, the companies were able to make profits that represented an excessive return on the value placed on them at the time of their flotation. We are now putting right the failures of the past by levying a one-off tax." (Column 201, *Hansard Commons*, 15 July 1997)

However, the Conservative Opposition on the Finance Bill, under Peter Lilley MP, by then Shadow Chancellor, appeared to have no doubt that this was a tax on excess profits. In the same debate, he remarked: "*They* [the Government] *have taken average profits over four years after flotation. If those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess.*" (Column 204, *Hansard Commons*, 15 July 1997)

As the debate progressed, he re-emphasised his view that this was all about profits: "*Essentially, the windfall tax boils down to a tax on success. Companies that failed to improve their profitability over the said period will pay much less or even no windfall tax. Some companies are complaining that other companies in the same industry that were conspicuous failures in modernising, improving and increasing their profitability and efficiency will pay little tax, while those that have done most to invest,*

reform their working practices and diversify into other businesses will pay most.

I understand that companies that have diversified into new ventures, even if outside the regulated activities, will pay windfall tax on the benefits of diversification. I stand open to correction by the Minister if that is not the case. As he does not correct me, I assume that I am correct and that the Government will impose a windfall tax on profits made in areas other than those in which the company was operating at the time of privatisation and other than in directly regulated areas. That is an indication that the Labour party has not changed. The Labour party still believes that profit is a dirty word. The more profits people make, the dirtier they are and the bigger the tax they should have to pay. That is the essence of the proposal before us." (Column 205, *Hansard Commons*, 15 July 1996)

Ross Cranston MP, who was one of many who spoke in the debate, summarised the popular view about the nature and rationale of the tax: "*As the Bill makes clear, this is a one-off tax on the excessive profits of privatised utilities—although Opposition Members have raised the possibility of further one-off taxes. There is no doubt that the appalling behaviour of those at the top of some of those utilities bolstered our case for the tax, but there were three principal justifications for it.*

First, there was the undervaluation of the assets at the time of privatisation: that is why the formula referred to in the Bill mentions the price placed on the utilities at the time of sale. Secondly, many of the companies continued, and continue, to be

monopolistic suppliers of essential services. That is why the Bill identifies the industries that will be subject to the tax in terms of economic regulation.

Thirdly, the original price controls set by the Conservative party on privatisation were excessively generous. There is no doubt that the companies made excessive profits: nearly every privatisation on which the Public Accounts Committee reported was said by the PAC to have involved excessive profits—and those profits were, of course, at the expense of consumers. The Bill identifies those justifications, which provide the case for the Windfall tax." (Column 228, *Hansard Commons*, 15 July 1997)

The evidence suggests that the House of Commons appeared to believe that it was passing legislation that enacted a tax on excess profits; and that the by-now-popular belief that the utility companies had been underpriced on flotation was part of the justification, but not the essence of the tax.

The importance of the influence of politics and presentation on the design of the windfall tax proposal should not be underestimated.

4. The design of the Windfall Tax

This section is divided into four parts. In the first, I provide a brief history and chronology of the Windfall Tax project. In the second, I set out a summary of how we approached the work. In the third, I explain some of the broader economic policy context for the work, as it was presented to us. In the fourth, I comment on the design of the Windfall Tax in the context of this case.

4.1 History and chronology

I first met Geoffrey Robinson, Member of Parliament for Coventry North West, at the request of Stephen Hailey on 12 June 1996. At that first meeting, he said two things that defined the project that we were about to undertake.

- First, that he assumed I was familiar with the public statements the party had made about introducing a windfall tax on the excess profits of the privatised utilities.
- Second, they had tried for some time to formulate such a tax but had failed and he had now been given responsibility by Gordon Brown for getting the design work done and he wanted to see it done properly. The task was urgent and they wanted our expert help to design it.

The approach that we took to the project was framed by those two statements.

The work on the project began immediately. There was a series of internal meetings at Arthur Andersen to deal with resources and look at the initial issues. Chris Osborne and I were to lead in our respective areas. Stephen Hailey, though not involved in any of the design or analytical work, would have oversight of the project. We recognised that this was a very substantial project, that it was highly unusual in nature if not unique among the work that the firm had ever undertaken and that our involvement in it could have a major impact on the firm's relationships unless all aspects of it were handled with the highest degree of professionalism. It had the potential to

enhance, significantly, our relationship with the Labour Party and a likely future Labour Government but could also potentially damage our relationships with our clients in the utility sector. We recognised that, in our interests and in those of the Labour Party, it was essential that the work progress on a completely confidential basis until such time as Gordon Brown was prepared to make a detailed statement about the Party's proposals. We understood that that was unlikely to be for some period and perhaps not until after the General Election.

It was clear from the start that we would need expert input on legal issues outside the tax area. These would include the European Convention on Human Rights and the impact of the European Union treaties on any proposals we developed. The Labour Party had a close relationship with a senior Queen's Counsel [QC], Michael Beloff at Gray's Inn and he and one of his juniors, Rabinder Singh, were chosen to advise. Wedlake Bell, solicitors, were appointed to give formal instructions to Michael Beloff because, at that time, only solicitors were entitled to instruct Counsel. However, all the instructions to Michael Beloff were, in practice, drafted by me. During the course of the project, there were, I believe, meetings with Counsel on four occasions. A joint opinion from Michael Beloff and Rabinder Singh was Signed on 31 October 1996.

I assigned a team to the project that comprised a manager, Robert Coxon, and a more junior member of staff, Christopher Sanger. In practice, most of the work was undertaken by me and Christopher Sanger.

Chris Osborne made similar arrangements for his support team on the financial analysis. Their work focused on the underlying financials of the companies that were likely to be subject to the Windfall Tax, on their ability to pay at given levels of tax and on the market performance of those companies since privatisation. This work proceeded in parallel with our work on the design of the tax itself and the two were linked together through a series of meetings. I have noted ten internal meetings at Arthur Andersen on the issues during July 1996.

I cannot recall on what date the fundamental principle for the tax was established in my mind. I do recall that I put the idea first to Robert Coxon and then to a broader meeting of the Windfall Tax team. It was refined in discussions with Chris Osborne, Christopher Sanger and Stephen Hailey. However, I am certain that the idea was established early enough for us to have addressed it with Counsel at our second meeting with them on 24 July. From that point, although a number of options were kept open, the work was focused more on development, refinement and checking than on establishing the fundamental principles.

By the end of August, I was ready to test the principles and much of the detail of the tax with someone who had not been involved in the process at all. I decided that I would like to talk it through with Leif Mutén, Professor of International Tax law at Stockholm School of Economics and I travelled to Stockholm to meet him on 29 August 1996 to discuss it. I was confident that he would bring both intellectual rigour and wide experience to the subject.

I was also aware that he was unlikely to view the proposal favourably and would, therefore, give it a sterner test than others might. I was correct on both counts. It would be fair to say that he did not like the proposal. However, although we took a number of the specific points that he raised to a subsequent meeting with Counsel in the UK, we concluded that there were no substantial legal barriers to progressing the tax as we had planned. The work proceeded through September and into October. Our final meeting with Counsel took place on 24 October, after which their formal opinion was produced and signed.

On 6 November 1996, the Arthur Andersen team gave a presentation to Gordon Brown at the firm's offices. The presentation focused on the extent to which the privatised utilities might be able to bear a one-off additional tax; the theoretical ways in which a windfall tax might be structured; the explanation why most of them were unattractive in our view; the reasons why we felt there was just one particular approach that we could recommend; and the potential yield and the wider implications of the Windfall Tax proposal. We also discussed the possibility of some further refinements. We demonstrated the presentational linkage that could be made between the mechanics of the tax, as we envisaged it, the underlying rationale for the tax and the popular notion of undervalue on privatisation. At that point, the shape of the Windfall Tax, as subsequently enacted in 1997, was effectively settled.

4.2 The Economic policy context for the Windfall Tax

In this section, I set out the economic policy context for the Windfall Tax project as it was presented to us by the Labour leadership.

The project parameters were set in the early discussions and meetings with Geoffrey Robinson and Ed Balls. From the start, there was never any doubt that our task was to design a windfall tax on the excess profits of the privatised utilities. That phraseology was extensively used and it defined our mission. That is what we all believed the "Windfall Tax" to be.

We took on board the context and rationale for the tax that Messrs. Robinson and Balls described and we developed alongside that a financial, economic and legal analysis to inform our decisions in designing the tax.

In setting out the political analysis in the third section of this report, I have dealt with much of the rationale for the tax. However, the economic policy context and its influence on how we saw the project at the time, needs a fuller explanation. The context that they gave us established the importance of the Windfall Tax to Labour's proposed economic policy programme in broadly the following terms.

At the time at which we undertook the work, the Labour leadership believed that it had sufficient support from the British electorate to form the Government after the next election and had, therefore, been preparing its approach on various

aspects of policy in some detail, in anticipation of taking office before the summer of 1997.

One of the areas of immediate concern was to provide training that would enable the young unemployed in particular to become better equipped for the demands of the jobs market. This would require a substantial injection of additional resources and was considered to be likely to cost at least £4 billion. This funding was not readily available from traditional sources because of the then Conservative Government's strategy of reducing income taxes and because of a serious shortfall in corporation tax and value added tax receipts. It could not easily be made available from these sources without a significant increase in rates.

Under Tony Blair's leadership, the Labour Party had tried to distance itself from the *tax and spend* image that it had, rightly or wrongly, acquired in the 1970s and 1980s. He had said that no individual should have to pay more than half of his income in taxes. This particular statement had not been the subject of close examination or media attention but there was, nevertheless, a general expectation that a Labour government would not put up income taxes above that level and that only those with significant levels of income would pay at the top rate.

In preparing for the election, the Labour leadership had been careful, in public statements, to avoid a firm commitment to a particular taxation strategy. Front bench spokesmen referred to the *growth dividend,* representing the natural financial and economic benefits that were judged likely to arise in the medium term from their growth strategy for the

economy, a central factor in which was their intention to put more of the unemployed back into productive work through education and training. They recognised, however, that to create this inter-generational benefit, the process had to be started somewhere and that it would have to be funded initially from taxation.

Aware of the likelihood that they would need to be very specific in the run-up to the General Election about how they would fund their approach to unemployment, the Party had, therefore, made one firm commitment on taxation. It had said that, in order to fund its training programme, it would levy a *windfall tax on the privatised utilities*. No specific figure had been given for the intended proceeds but they were widely believed to fall within the range £3-5 billion.

The Labour leadership was naturally concerned to ensure that it could raise the projected revenues and that its proposals would pass detailed scrutiny. As part of that process, we were to help with the identification of the target taxpayers, the justification for levying the tax, the setting of a basis for levying it that would distribute the burden *fairly* among the taxpayers and the impact on the taxpayers themselves of given levels of taxation. We were to use Counsel to comment on the likely robustness of different tax proposals against challenge from the taxpayers under UK and European Community law and under the European Convention on Human Rights.

4.3 How we approached the design of the tax

In this section I summarise our approach to the scope and key design features of the Windfall Tax.

4.3.1 Identifying the taxpayers

The Labour leadership had a broad view of an appropriate class of taxpayers on whom the *windfall tax* should probably fall but they had no specific definition in mind when we commenced the work. The identification of the taxpayers emerged from a blending of their political instinct and our analysis tempered by consideration for the likely legal constraints. We started from their premise that the privatised water and sewerage companies (WASCs) should fall within its scope, together with the Regional Electricity Companies (RECs). The English electricity transmission system, the National Grid, and the English electricity generators, PowerGen and National Power should also ideally be included. The Scottish electricity industry was structured in a different way, with the generation, transmission and supply industry being vertically integrated within two companies that performed all three functions, namely Scottish Power and Scottish Hydro. As a starting point, it seemed appropriate to include those companies in the scope of the tax.

The majority of those companies took over businesses that were government-owned until the late 1980s. Most were privatised in 1989/90 and were still independent companies, quoted on the London Stock Exchange, although there had been a recent upsurge of interest in the water and electricity industry which had resulted in a number of them being acquired by

other quoted companies. They operated, in their own geographical areas, as monopoly or near-monopoly suppliers and were subject to regulation, including price regulation, by bodies set up by Government for that purpose. Almost without exception, they had been extremely profitable since privatisation. The argument that they were privatised too cheaply had been dismissed by the National Audit Office but was still held to be true in popular political debate. There was also a strong body of opinion that at least some of them had been subject to a regulatory framework that was too slack and that had permitted the profitability of the privatised companies to be excessive in the early years after privatisation. In any event, shareholder returns in this sector had been very good. In comparison with returns on the FTSE all share index over the period since privatisation, the WASCs had significantly outperformed the index. The RECs had produced even stronger returns since privatisation.

There was a certain logic in including within the scope of the tax, the main gas supply company in the UK, BG, which had had a monopoly or near-monopoly position throughout the country since privatisation. However, it was perceived to have been relatively poorly managed and, in the year prior to our project, total compound shareholder returns to BG shareholders had fallen below the average for companies in the FTSE all share index.

Another major utility company to have been privatised was BT, which then faced the most competitive situation of any privatised utility in the UK. As with BG, the total compound return on its

shares had, in the year before the commencement of our work, fallen behind that of the companies in the FTSE all share index.

These companies were considered likely to form the total body of taxpayers who would fall within the scope of the windfall tax. However, the dividing line was not entirely clear. There was a view that it would be unreasonable to the shareholders of BT and BG to impose additional taxes on those companies and that they should, therefore be excluded. However, both companies had been highly profitable and enjoyed strong cash flows even if the market did not necessarily reflect that consistently in their share price.

There was also a debate over whether the class of taxpayers should be widened to include other privatised companies that had a monopoly or near monopoly position, such as the British Airports Authority, Railtrack, and the Train Operating Companies that provided passenger train services as monopoly supplier in their separate geographical areas, (run before privatisation by British Rail). These would all probably have fallen at that time within a popular consensus definition of *utility*. The line had to be drawn somewhere, but it was certainly not clear from Labour Party policy statements exactly where it would be drawn.

I recall that we experimented with a number of possible definitions. There was early consensus around the need to include references to both privatisation and regulation by statute but we were aware that the legislation would have to be more tightly framed than that. There was quite a lot of

concern that the definition should be crafted in such a form as to prevent the Bill from becoming what is known in parliamentary terms as a *Hybrid Bill*. I believe the Court has previously received submissions in which the concept of a hybrid bill has been explained. It is referred to in current guidance in the following manner: "*A hybrid bill has characteristics of both a public bill and a private bill. Although of general interest, the content of the bill would significantly affect the interests of certain individuals or organisations ... a public bill that affects a particular private interest in a manner different from the private interests of other persons or bodies of the same category or class*". *(House of Commons Information Office*, Hybrid Bills, *Factsheet L5 Legislative Series, Revised February 2005)*

The principal concern was broadly that the class of taxpayers should be capable of precise definition without reference to the individual companies. A bill that failed that test might have been a *Hybrid* and, therefore subject to additional Parliamentary procedures. There was also a risk that it would not have been treated as a *Money Bill* by the Speaker and could, therefore, have been susceptible to delay, challenge and amendment in the House of Lords. Given the importance of the Windfall Tax proposals and the tight legislative timetable for the summer of 1997, delay and uncertainty in the Parliamentary process would have been unacceptable. The fact that the House of Lords still had a Conservative majority was an added complication.

Taking all the factors into account, the definition of the taxpayer class came to rest on the concept of

privatisation by flotation and subjection to economic regulation. This gradually emerged from our work with the Labour team over the summer and autumn of 1996. The particular significance of the decision to add the "flotation" test was that it led to the exclusion from the scope of the Windfall Tax of a number of companies such as the National Grid that had been transferred into the private sector by other means. The precise definition included in Finance (No.2) Act 1997 was the work of UK Government parliamentary counsel who draft all legislation, rather than the Andersen team.

4.3.2 Determining the nature of the tax

If we had been given a brief simply to design a one-off tax on the utility sector, it would, potentially, have been possible to base it on almost any measure that delivered the required amount of tax: turnover, gross asset values, book net worth, book profit before tax, profits for corporate tax purposes, a measure of "excess" profits or book profits after tax; but the fact and the substance was that we had been instructed to design a windfall tax on the excess profits of the privatised utilities. So although, in the early stages of the project we listed all of the bases that might theoretically be used, to test whether they were doable in principle, they also had to be subjected to the more significant test of whether they could deliver an acceptable result in the context of the brief that we had actually been given. We ran through several of them with Gordon Brown when we made our presentation in November 1996, to show why we felt they were not appropriate. Some of them were certainly doable in principle. Some of them responded

more directly than the final design to one or other aspect of the underlying rationale for the tax itself. However, we felt that there were serious technical, presentational or political issues with almost all of them which meant that we could not recommend them to the Labour leadership.

It was a complex problem. Even a cursory review of the published accounts of the likely taxpayer companies suggested that most of the bases we listed would have spread the tax burden between the different utilities in a way that could have been seen as highly unsatisfactory if not unfair. Other methods raised legal, presentational or economic policy issues that we felt would make them unattractive.

We considered but rejected mechanisms to tax directly a defined measure of excess profits or to tax "regular" profits additionally. We recognised that a pure profits tax would probably be seen by both the taxpayer companies and the general public as the most normal type of tax. Profits were, arguably, the best measure of corporate performance and taxing them more fully would have responded well to the basic premise underlying the windfall tax proposal. However, we also recognised that there would have been some problems with this approach. In the first place, we were not really looking to design too "normal" a tax. This was to be a one-off measure, not one that looked capable of enduring or being repeated. Conceptually, the issue was not about the current level of profits in the companies concerned so introducing a prospective additional profits tax seemed to address the wrong point. More practically, a one-off profits tax, to be enacted on a prospective

basis, would have been relatively easy to avoid if it was to be based on the existing rules from the corporate tax system; and there would have been some additional difficulties, not least relating to the availability of deductions etc. This could have been overcome by creating a whole new set of special rules but, for a one-off profits tax, that was judged undesirable. One option would have been to develop a simple tax imposed on published historical profits but we felt at the time that the naked retrospectivity of this idea would set a very undesirable precedent and could dramatically colour perceptions of the incoming Government.

A tax levied directly on a defined measure of "excess profits" would have responded well to our basic brief and was, therefore, attractive in principle. However, we felt that there would be significant problems in determining an explicit legislative definition of "excess". We felt that approaching the issue of "excess" in that way would generate an unwelcome level of attention in debate in the House of Commons and could create difficulties for the incoming ministerial team. We considered that it might be difficult to apply a single measure of "excess" consistently across the utility sector and we were not attracted to the idea of a tax that used several different measures. In determining to which profits the tax would apply, we recognised that we would face the .same issues about making the tax prospective or retrospective that we faced in considering a pure profits tax.

We were looking for an ideal solution: a tax that would be simple to calculate, difficult to avoid, cheap

to collect and certain as to yield, one that would be seen to be broadly fair in its incidence as well. My intention in taking on responsibility for the project and the design of the tax, indeed the collective intention of the team, was to create something that was undeniably intelligent as a taxing mechanism; something that combined the political message that the Labour leadership had been putting out with the technical approach of the design itself; something that would signal that a Brown Treasury would be a force to be reckoned with, successful and professionally run; something that would set new standards. It was a flagship piece of policy. So we were looking for a solution that brought principle, rhetoric and all the underlying rationale together, not for a compromise solution. The question was how to deliver a tax that was true to the intent of the Labour Party leadership and their public statements, that was in harmony with the political arguments that had been made for it and that avoided all the potential pitfalls in UK and European law and treaties.

In reality, we came to the essence of the answer very quickly. Once thought of and discussed among the Andersen team, it was obvious to all of us that it was the right approach; and it quickly became obvious to the political team as well. We continued to explore other ways of achieving the objective but we struggled to find anything that worked as well from a presentational perspective while meeting the economic and legal requirements and delivering a result that was broadly fair in its incidence and distribution. Our answer to the design brief was to levy a tax that was based on excess profits during the

immediately post-privatisation period when the regulatory regime was most benign; that used in the calculation of the liability a range of publicly available market reference points to strengthen its legitimacy, such as the privatisation share price, the published profits of the privatised utilities and the price/earnings ratio of the companies concerned; and that would be enacted by legislation that was substantially similar to an existing piece of tax legislation, the operation of which had been specifically disapplied in the context of almost all of the Conservative privatisations. That approach became the Windfall Tax. And it became possible to sell it to the public, to the House of Commons and even to the expert commentators, from a presentational standpoint, on the twin pillars of excess post-privatisation profits and the putative underpricing of the shares at flotation.

It has been put to me, in the course of the discussions around this case, that the Windfall Tax was a tax on value. It is for the Court to determine whether, under US principles, that is so. I can, however, say that I was instructed by the Labour team to design a windfall tax on the excess profits of the privatised utilities and was not at any stage asked to design a tax on value or on the difference between two values. Had it been my intention to design a tax on value, it is inconceivable that I would have constructed the tax in this way. As a tax on value it would, at best, have been clumsy and inelegant, at worst, simply crass. If the Windfall Tax, as enacted, had been designed as a tax on value, I would have been embarrassed by it. I would also have recommended that the political handling of the introduction of the

tax be quite different. If the Labour leadership had seen the tax as anything other than a tax on the excess profits of the privatised utility companies, there would have been no need for them to have continued to refer to the Windfall Tax in that way. And, of course, they were not the only people to see it as a tax on excess profits. As I have evidenced in the previous section of this Report, members of Parliament, including the Conservative Shadow Chancellor at the time, clearly saw it as taxing excess profits.

4.3.3 Sorting out the detail

In this section, I comment on some specific matters of detail regarding the design of the tax.

4.3.3.1 Retrospection

As I have indicated earlier, one of the objections that we had with the idea of a profits tax or an excess profits tax that used historical profits as its base was a concern that introducing a retrospective tax of this scale in its first Finance Bill might damage the image of the incoming Labour Government. The Windfall Tax, as we designed it, was a tax on historical profits. In spite of our philosophical objections to the idea of a tax that looked back to historical profits, we became comfortable with this, as a team, for a number of reasons. The main reason was that the historical profits we taxed were those of the immediate post-privatisation years. These were the years, different in a calendar sense for each company but identical in concept, in which regulation, in the rhetoric of the time, had been most benign and efficiency gains achieved most dramatically. So to have taxed the

profits of any other period or periods would have been perverse and would have run counter to the political argument.

4.3.3.2 Use of book profits as the base

We debated what profit measure to use but concluded that the figures from the published accounts were the best ones. There were a number of reasons for this. One was transparency. The numbers were readily available in the public domain and could quickly and easily be factored into a calculation of the liability. Using profits adjusted for corporation tax purposes would have skewed the outcome and made the process of calculation laborious and practically impossible for anyone outside the company including, most importantly, the analysts in the City. The published figures from the companies' financial statements took into account all the relevant income and deductions, including financing costs and so were "normal profits" in any conventional understanding of the term. They also included the profits of activities outside the immediate regulated businesses that were conducted at the time by the entities concerned. We considered whether it was appropriate to include those profits but concluded that it was. Had we been aiming to compare, in any conventional sense, actual and (hindsight-based) notional values of the businesses at privatisation, we could not, of course, have done that. Using the published profits of the companies made it easier for us to use a market-derived price-earnings ratio in the mechanics of the tax which itself strengthened the transparency we were seeking.

The use of post-tax profits was also a factor here. It tied together the issue of transparency and market reference points. It also re-affirmed that this was an additional tax on top of the normal corporation tax. It was not deductible for corporation tax purposes and stood alongside corporation tax as an additional charge on profits. In my time at the Treasury, new taxes that were not profit taxes were generally allowed as deductions for corporation tax purposes. It is, therefore, significant that this was not. The supplementary rate of corporation tax on North Sea oil companies that we introduced in 2002 was not deductible for regular corporation tax purposes. Like the Windfall Tax, it was conceptually a tax on profits even though the base was somewhat different from the regular corporation tax. Using post-tax profits for the Windfall Tax spread the tax burden among the utility companies in a way that ministers considered to be more appropriate than a tax based on pre-tax profits.

4.3.3.3 Economic efficiency

One of the principal concerns from an economic policy perspective in levying the Windfall Tax was that it might create distortions, damage investment and lead to job losses. This was an issue that was well-understood by the Labour team and that was used by the industry in their pre-election opposition to the proposal for a tax. So it was one of the attractions of the design of the tax that it was not only a one-off levy but that it was based on historical profits. It was unlikely to give rise to any behavioural change by the utility companies other than change occasioned by the payment of the tax itself; and it was unlikely to

give grounds for the regulator to agree to an increase in the prices charged to consumers.

4.3.3.4 Was the tax base fixed and immovable?

The fact that the tax was levied on historical profits did not, however, mean that the profit figures on which the tax was levied were fixed and immovable. In reality, the profits were the only parts of the calculation that were movable.

I am aware that one of the issues that has been raised in connection with the Windfall Tax was whether the amount that was payable by each company was absolutely fixed and determined at the time at which the legislation was enacted. It is relatively easy, on an initial reading of the law, to come to the conclusion that, because the tax was based on historic profits, the profit must have been as fixed as the tax rate and the price/earnings multiple that was used and that there were, therefore, no "moving parts" in the application of the formula for the tax. However, this was not the case. In reality, the profit figure could move and, in the case of one company, that possibility was demonstrated in practice.

The issue arose in the context of an accounting adjustment that had to be made by South West Electricity plc (SWEB). I am not aware of any similar cases in which accounting adjustments were made that resulted in changes in the Windfall Tax liability of other utility companies, but following from SWEB's example, there was no reason why that could not occur. The adjustment in SWEB's case resulted from an apparent failure by the company to account

properly for certain anticipated costs in relation to line maintenance. I believe these were the costs of trimming and cutting back hedges and trees close to power lines to prevent possible damage to those lines. The nature and scale of the costs was such that it required a restatement of the company's accounts that affected the accounting profit for the years on which the Windfall Tax was based.

At that time, I met representatives of the company and their advisers in order to get a better understanding of the nature of the adjustment. As a policy-maker, I recall that I was satisfied that if the accounting adjustment was proper, it should have a natural effect on the Windfall Tax payable. In this case it meant that SWEB's tax liability should be smaller because the profits for the year in question were lower than had previously been reported. Based on the information that I received, I could see no reason why that reduction should not be made. I believe that the Inland Revenue, who acted independently in such matters from HM Treasury, chose to challenge this outcome but that their challenge was not sustained. We did not expect, at the time of designing the tax that the profits we were taxing would shift significantly. It was important for the policy programmes that the Windfall Tax was intended to fund that the proceeds were reasonably certain and bankable. However, it was also important that the determination of the profit base was fair and consistent.

4.3.3.5 Could an unprofitable company have paid the Windfall Tax?

It may be relevant to the Court, in determining the nature of the tax for US purposes, to consider whether a company that made no profits at all during the period of up to four years following its privatisation by flotation could have incurred a Windfall Tax liability. It was not our intention in designing the tax that such a possibility should arise. Nor was it possible, in the context of the legislation that was enacted in 1997, for there to be such an outcome. Profits were not Simply a predominant factor in the calculation of the liability, they were a necessary attribute for the company to have any liability at all. The Windfall Tax did a very normal thing. It started with a figure for realised profits and then adjusted it in accordance with a set of rules prescribed in the legislation. If there were no profits, the liability would always be zero.

4.3.3.6 Form of the Legislation

I understand that comments have been made about the relevance to this case of the precise manner in which the Windfall tax design was legislated. It might be helpful to clarify a number of points around this.

Firstly, in the UK, government legislation is and, at least in recent times, has virtually always been drafted by parliamentary counsel. Parliamentary counsel are civil servants and, therefore, employees of the Crown. They have historically been very few in number at any one time and, it would be fair to say, the skill and expertise that they bring to the task

have generally justified the jealousy with which they guard their rights to do all the drafting. At the time at which the Windfall Tax was designed, they would work closely with the instructing Government department, in this case, the Inland Revenue, to give effect to what had been agreed by ministers.

Secondly, HM Treasury, again working closely with the Inland Revenue at that time, was the Government institution responsible for proposing tax policy measures to ministers. This was a role that they also guarded jealously. It was not, therefore, surprising that they had worked up their own version of a Windfall Tax on the privatised utilities that they put before ministers shortly after the 1997 election. I now have only a slight recollection of the form of the tax that they proposed. I believe it was linked to a measure of value and shareholder returns and I recall that one of the reasons that it was rejected by the then Chancellor, Gordon Brown and by Geoffrey Robinson as Paymaster General, was that it could not be said to be taxing excess profits. The proposal for the tax did not accord with the political case. Instead they decided to use the design developed by the Andersen team.

This was a very unusual situation for the Treasury. It was considered highly irregular that a team of outside experts had designed a tax that ministers intended to legislate and even more irregular that we had, at the Labour leadership's request, created a preliminary draft of the legislation itself. In the event, although our design for the Windfall Tax was adopted and legislated, the final wording in the Finance Act was not the draft legislation that we

produced with the assistance of Sir Peter Graham. It was parliamentary counsel's own work.

The change of authorship led to some changes in the details of the tax. In the design of the Windfall Tax that we created, we envisaged the tax being part of the existing framework of tax legislation rather than a separate part of the statute. We did so for a number of reasons. The principal reason, which now seems remarkable to me in retrospect, was our concern that, given the potential scale of the charge, companies might simply refuse to pay. There had already been threats from some companies that they might not pay and we took those comments quite seriously. In any event we were anxious to avoid both litigation and delay in the receipt of payment. So, at an early stage in the process, we took a decision to use principles that were indisputably part of existing law and practice wherever we could and to use language that could be found in existing law.

It is difficult now to see this as anything other than paranoia on our part. The tax was paid on the due dates. There were no collection difficulties and there was almost no challenge to it. It proved to be highly successful as a taxing measure. However, in the run-up to the General Election, with the prospect of a Labour Government for the first time in 18 years, it was possible for us to imagine a very different outcome.

This paranoia clearly did not extend to the Treasury officials or to parliamentary counsel, for whom it would presumably have been inconceivable that taxpayers could simply refuse to pay a tax levied in a Finance Act. This gave them the freedom to approach

the legislation in a slightly different way. As history shows, although the essence of the tax was, as we intended, substantially similar to existing UK tax law and leaned heavily on a. provision that had been disapplied on most of the privatisations, the Windfall Tax was enacted as a separate tax rather than in the framework of the existing tax legislation as we had envisaged. By drafting the legislation as a separate part of the Finance Act, it dropped more quickly out of sight than it would otherwise have done, which had presentational benefits. It became easier for the Labour leadership to enunciate effectively the political message that this was a "one-off" tax. It also gave the Treasury the ability to flex the yield in a manner that we had not allowed ourselves, for example by moving the rate at which the Windfall Tax was levied away from mainstream corporation tax rate which was then 33% to the 23% that was finally used.

I am not sure whether the phrase "*the value in profit-making terms*" that appears in Schedule 1 to the Finance (No. 2) Act 1997 (which deals with the quantification of the privatisation windfall), was present in the Andersen draft but I think it is unlikely that it was. I am not aware that it has been used in tax legislation before or since. However, I suspect that it reflects an understanding on the part of parliamentary counsel that the relationship between the tax and the taxpayer companies' profits was of some importance. There could have been no other purpose in putting in the words "in profit-making terms" than to direct the mind towards the profits issue. If the Windfall Tax had not been seen by civil servants in the Treasury departments or the

Office of Parliamentary Counsel as a profits-based tax, I believe it is unlikely that this phraseology would have been adopted. Treasury ministers, in my experience, never saw the wording of draft legislation before its publication and are unlikely to have done so on this occasion or, therefore, to have expressed any view on this wording so it is difficult to see its inclusion as the result of a ministerial decision.

4.3.3.7 Exceptions

Among the companies within the scope of the Windfall Tax, a number did not have four years of profits to bring into charge. These were the companies that had been privatised most recently in relation to the 1997 General Election. In considering how to deal with them in the legislation, we had a choice. We could either leave their position open and impose the Windfall Tax on them once they had four years of results or we could use their published results to date as the basis for the tax. We chose the latter. Although it is important that tax law should reflect clear principles and apply them consistently, it is also important to be a little pragmatic in deciding how to deal with anomalies and exceptions. Anomalies and exceptions occur in all tax policy-making. In the real world, as a policy-maker, you do the best you can to make the operation of the tax as consistent and fair as possible but fairness and simplicity are at opposite ends of the policy-making spectrum and ultimately you have to decide how to deal with the issues that simply do not fit in the regular pattern. Normally, the exceptions are not allowed to distort the main intent and in the case of the Windfall Tax, the position of the most recently

privatised companies simply had to be managed to maintain the coherence of the tax. The simplest way to do that was to include the profits that they had made to date in the calculation of their liability. The fact that that might affect their effective rate of tax was not regarded as an issue of sufficient consequence for it to require a different approach. At the time of the 1997 Budget Treasury ministers were more focused on avoiding the risk that the few companies affected might seek to manipulate their profits and their tax liability than with the possibility that the treatment of some of them might seem slightly anomalous. The same is true for the application of the Windfall Tax principles to the companies privatised in a series of flotations. We took a pragmatic approach. I do not believe that the treatment of the exceptions under the Windfall Tax proposals provides any helpful guidance on the nature of the tax itself.

4.3.3.8 Our consideration of the likely creditability of the Windfall Tax

In designing the Windfall Tax, I was aware that there was an issue as to whether it might or might not be creditable under the tax law of another jurisdiction. My view was and remains that creditability is essentially a matter for the authorities of that other jurisdiction. At the time at which we designed the tax, I had a broad expectation that it would be creditable but I did not include it as a conscious policy objective that it should be. We designed the tax to fall on UK utility companies but whether it was ultimately borne in some cases by non-UK parent companies or effectively borne by a

foreign government was not a matter to which we gave much attention during the project other than in one specific context.

That context was the European Community (EC) rules on discrimination. Creditability was specifically discussed with Counsel in the context of whether, under EC law, it could be regarded as discriminatory that a credit might be available for the Windfall Tax under one country's law but not another's. Counsel opined that EC law would not operate in that way but did not address the substantive issue of creditability and was not asked to do so.

As a natural part of my role at HM Treasury, I met the management of utility companies and their tax counsel on several occasions. I also met representative bodies of the utility sector. The Windfall Tax was raised as an issue on a number of occasions but there were few specific comments or questions about the detail of the tax and I have no recollection that the creditability of the Windfall Tax for US purposes was ever raised with me at that time by representatives of the taxpayers.

I do recall, however, that the issue of creditability was raised by officials in the Treasury at one stage and that the view that I expressed at that time was that which I have set out above, namely that the issue is one primarily for the authorities in the other jurisdiction.

5. Conclusions about the design of the Windfall Tax

In the *Introduction and summary of key points* to this Report, I have sought to draw the Court's attention

to what I believe to be the key issues regarding the design of the Windfall Tax.

The Andersen team was instructed to design a tax on the excess profits of the privatised utilities and we sought to do that in a way that would bring principle, rhetoric and all the underlying political and economic rationale for the tax together.

We rejected a number of possible mechanisms for the tax, some of which responded more directly than the final design to one or other aspect of the underlying rationale for the tax. We did so because of serious technical, presentational or political issues which meant that we could not recommend them to the Labour leadership.

We devised a mechanism for taxing those excess profits that had presentational benefits because:

- it based the tax on the excess profits that each of the taxpayer companies had earned in the years immediately following their privatisation, when regulation was most benign;
- it used a range of publicly available market reference points, which improved transparency, to strengthen its legitimacy;
- it created a linkage between the tax and the popular view that the utility companies were sold off too cheaply;
- it was substantially similar to existing legislation that had been specifically disapplied in relation to most of the privatisations; and

- it led to a distribution of the tax burden among the utility companies that we believed would be accepted as broadly fair and, on the basis of its final scale, was well within the means of all of the companies affected.

The importance of the influence of politics and presentation on the design of the windfall tax proposal should not be underestimated.

The Labour leadership, members of the House of Commons and commentators at the time regarded the tax as a tax on the excess profits of the privatised utilities.

Had it been my intention to design a tax on value, it is inconceivable that I would have constructed the tax in this way. As a tax on value it would, at best, have been clumsy and inelegant, at worst, simply crass. Our intention was the opposite: to create something that was undeniably intelligent as a taxing mechanism, something that would signal that a Labour Treasury under Gordon Brown would be a force to be reckoned with.

We dealt with exceptions to the basic premise of the tax on a pragmatic basis that should not colour consideration of the tax itself.

We did not specifically aim to create a tax that would or would not be creditable for the purposes of the tax systems of the US or any other jurisdiction but we were aware that, because of both the substance and the form of the tax, it might be considered creditable under US rules. For our purposes, the main question was whether the imposition of the tax might give rise to a challenge under EC law on the basis that it was

creditable in one jurisdiction but not another and, therefore, discriminated against certain shareholders.

I do not purport to be an expert on US taxation and I do not offer an expert opinion as to whether the Windfall Tax is a creditable tax in the US for the purposes of the UK-US Double Taxation Convention or meets the relevant tests in IRC Section 901.

However, I believe that I have evidenced the fact that the Windfall Tax was a tax that was intended to be based on realised profits and that was in fact based on realised profits. Profits were the only factor in the calculation that were movable and it was impossible for a company with no profits in the relevant period to have a Windfall Tax liability.

I have been compensated for the time that I have spent in the preparation of this report at my normal hourly rate of £1,000 per hour. The relevant amounts have been included in invoices submitted by LECG.

I have set out the background to the tax in some detail and I have explained the political and economic policy context in which it should be seen. I hope and trust that that will be helpful to the Court in its deliberations.

Christopher John Wales
8 September 2008
Gaddesden Hall,
Water End,
Hemel Hempstead,
Hertfordshire,
United Kingdom

[Appendices omitted in printing this appendix]

RECORD
AND
BRIEFS

No. 12-43

In the
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Report of Mark Ballamy
On Behalf of PPL Corporation and Subsidiaries

September 8, 2008

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SECTION 1

Introduction

1.1 I am a Fellow of the Institute of Chartered Accountants in England and Wales and am a partner in the firm of Ballamy Woodhouse which specialises in financial and fraud investigations. I was employed by Price

Waterhouse from 1979 until 1991 when I was admitted to the UK partnership of that firm. Between 1991 and 1993 I was seconded by Price Waterhouse to the Serious Fraud Office ("SFO") as an Assistant Director. On my return to Price Waterhouse in August 1993 I rejoined the Forensic Services department and, from 1996 to 1998, I was the partner responsible for the fraud investigation services provided by Price Waterhouse in the United Kingdom. On 30 June 1998 I withdrew from the Price Waterhouse UK partnership to establish Ballamy Woodhouse.

1.2 I have extensive experience of giving expert accounting evidence both in criminal and civil proceedings in the UK. Prior to my secondment to the SFO as an Assistant Director in 1991, I was instructed as the Prosecution's expert accounting witness in connection with three cases brought by the SFO. During my secondment to the SFO I was responsible for the financial aspects of a large number of investigations being undertaken by the SFO at that time. I acted as the Crown's expert accounting witness in connection with a number of these cases. Following the conclusion of my secondment, I have been engaged by the SFO to assist with a number of cases and have acted as the Crown's expert accounting witness.

1.3 I have been instructed by lawyers representing defendants to prosecutions which have been brought by the SFO. In most of these cases I have given evidence in the UK's criminal courts on financial reporting issues.

1.4 My curriculum vitae appears at **Appendix 1** to this report.

SECTION 2

Background to this dispute

2.1 The Conservative Party, led by Margaret Thatcher, was elected to power in the UK in 1979. Between 1979 and May 1997 when the Labour Party was elected to power under Tony Blair's leadership, a number of companies that were owned by the British Government were privatised. The process of privatisation involved the securities of these companies being sold to members of the public by the British Government by means of flotation on the London Stock Exchange. The process of flotation in the UK is similar to that associated with an Initial Public Offering in the United States.

2.2 Until late 1990 all regional electricity utilities in the UK were owned by the British Government. They were referred to an "Electricity Boards", such as South West Electricity Board ("SWEB"). Under statutory powers, property, assets, rights and liabilities were transferred from the various electricity boards to twelve regional electricity companies. In 1990 all twelve of these regional electricity companies were privatised by the British Government. One of these companies was South Western Electricity plc. Throughout this report I will refer to this company as SWEB—the entity having been referred to as South West Electricity Board before privatisation.

2.3 In 1996 PPL Corporation ("PPL"), through one of its subsidiary companies named Power Markets Development Company, purchased a 25% interest in SWEB by acquiring a 25% interest in Southern Investments UK Holdings Limited which had acquired SWEB in 1995.

2.4 In July 1997 the UK's Labour government introduced and enacted what was called a "Windfall Tax" on all companies which had been privatised since 1979 and which had become subject to economic regulation (which principally comprised statutory price controls) as part of the privatisation process. The majority of the companies that were subjected to economic regulation as part of the privatisation process were utility companies such as regional water companies and regional electricity distribution companies. I will describe the Windfall Tax in greater detail in Appendix 2 of this report.

2.5 As a consequence of the introduction of this Windfall Tax, SWEB charged its Windfall Tax liability of £90.4 million to its profit and loss account for the year ended 31 March 1998. Note 5 to these financial statements explained that this amount was payable to the UK's taxing authorities in two equal instalments—the first on or before 1 December 1997 and the second on or before 1 December 1998.

SECTION 3

My instructions

3.1 I have been asked by Hunton & Williams LLP, legal counsel to PPL and its subsidiary undertakings, to undertake the following tasks:

- calculate the Windfall Tax liabilities of all of the Regional Electricity Companies (Section 5),
- explain the UK's financial reporting requirements in the 1990s (Section 6),
- explain the UK's accounting and financial reporting standards in the 1990s in so far as these were relevant to the Windfall Tax (Section 7),
- explain the duties of the auditors of UK companies in the 1990s (Section 8),
- review the audited financial statements of SWEB for the years ended 31 March 1997 and 31 March 1998 (Section 9),
- explain the accounting treatment for Windfall Tax liabilities used by all other companies to which the Windfall Tax applied (Section 10), and
- explain how the marginal rate of Windfall Tax changes as the duration of a company's initial period shortens, and calculate the average rate of Windfall Tax suffered by Railtrack Group plc (Section 11).

3.2 In preparing this report I have referred to a number of sources of authoritative information. These sources include:

- The Finance (No.2) Act 1997
- The Companies Act 1985
- The Companies Act 1989
- Financial Reporting Standards and Statements of Standard Accounting Practice extant in the 1990s, and
- Statements of Auditing Standards extant in the 1990s.

3.3 I have also referred to the audited financial statements of the companies to which the Windfall Tax applied and I attach to this report relevant extracts of these financial statements. I obtained these financial statements from the UK's Registrar of Companies.

3.4 In preparing this report I have been assisted by others within Ballamy Woodhouse. Sid Harding and Megan Long, both of whom are Chartered Accountants, have worked under my supervision in preparing certain of the calculations and analyses which feature in the appendices to this report. Additionally, Noel Lindsay, who is also a Chartered Accountant and a partner in Ballamy Woodhouse, has performed our standard quality assurance procedures in connection with this engagement. These procedures involve a partner, who has had no involvement in the case, reviewing the final draft version of the expert's report for the purpose of challenging technical opinions.

3.5 Within this report I use an italic font whenever I quote text directly from a document to which I refer.

3.6 It is the normal practice of Ballamy Woodhouse to charge fees on either a daily or an hourly basis. The fees of Ballamy Woodhouse in relation to this work have been charged at our standard hourly rates. My hourly rate is £365 and our fees to date are £57,705.00. This amount excludes disbursements necessarily incurred in connection with the performance of our work. It also excludes Value Added Tax which is a type of sales tax applied in the UK at a standard rate of 17.5%.

SECTION 4

A summary of my principal conclusions

4.1 The Windfall Tax was introduced by the Finance (No.2) Act 1997 which required that the financial statements of a company by reference to which its profit for its initial period would be determined must have been prepared in accordance with the Companies Act 1985. The Companies Act 1985 required that companies' and groups' financial statements give a true and fair view. Paragraph 12 of Schedule 4 to the Companies Act 1985 required that "*only profits realised at the balance sheet date shall be included in the profit and loss account*". It was not permitted to include unrealised profits in the profit and loss account.

4.2 UK Accounting Standards were given statutory recognition by the Companies Act 1989, and

financial statements which do not comply fully with Accounting Standards are unlikely to give a true and fair view.

4.3 Statement of Standard Accounting Practice No.2 ("SSAP2") described the four fundamental accounting concepts with which companies' accounting policies and their financial statements must comply. Two of these four fundamental accounting concepts are the *accruals* concept and the *prudence* concept. These two concepts are defined by SSAP2 as follows:

The "accruals" concept

Revenue and costs are accrued (that is, recognised as they are earned or incurred, not as money is received and paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate—provided that where the accruals concept is inconsistent with the "prudence" concept, the latter prevails.

The "prudence" concept

Revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty; provision is made for all known liabilities (expenses and losses) whether the amount of these is known with certainty or is

a best estimate in the light of the information available.

4.4 The definitions of both the accruals concept and the prudence concept commence with the word "*Revenue*". The word "*revenue*" is no different in meaning from the word "*turnover*"—this being the word which Schedule 4 to the Companies Act 1985 requires to be used in companies' and groups' financial statements to describe *revenue*. The words *revenue* and *turnover* are synonymous, and they have the same meaning as gross sales.

4.5 The accruals concept requires that revenues and costs are recognised as they are earned or incurred and matched with one another so far as their relationship can be established or justifiably assumed. Consequently, amounts of profit shown by profit and loss accounts which have been prepared in accordance with the accruals concept are no different from amounts of net income—i.e. revenues less all associated costs.

4.6 The Council of the Institute of Chartered Accountants in England and Wales published a statement of guidance on the determination of realised profits in the context of the requirements of UK law. This guidance explains that "*a profit will normally be a realised profit if the accounting policy adopted is consistent with paragraphs* 12 *and* 13 *of Schedule* 4 [to the Companies Act 1985] *and with the accruals and prudence concepts set out in SSAP2*".

4.7 In the light of this authoritative statement of guidance, all profits disclosed by UK companies' profit and loss accounts prepared in accordance with Schedule 4 are realised profits unless there is a note to the financial statements explaining that unrealised profits have been included. None of the financial statements for the initial periods of companies to which the Windfall Tax applied contained a note explaining that unrealised profits had been included in its profit and loss account. Consequently, the profits by reference to which companies' liabilities to Windfall Tax were assessed were realised profits.

4.8 In the UK a company's auditors are required by law to make a report on the company's financial statements giving their opinion on whether the financial statements have been properly prepared in accordance with the provisions of the Companies Act 1985 and whether the financial statements give a true and fair view. The auditors' opinions on the financial statements for the initial periods of all of the companies to which the Windfall Tax applied were unqualified. Auditors would only issue unqualified audit reports if they were satisfied that the financial statements are free of material errors, disclosed all information required to be disclosed by the Companies Act 1985 and all applicable Accounting Standards, had been prepared using suitable accounting policies which were compliant with all applicable Accounting Standards and which were fully consistent with the four fundamental

accounting concepts, and gave a true and fair view.

4.9 SWEB was one of 32 companies which were chargeable to Windfall Tax. Of these 32 companies, 31 were liable to pay Windfall Tax. The only exception was British Energy plc whose profit in its initial period was insufficient in amount to trigger a liability to Windfall Tax. All of the 31 companies (including SWEB) that were liable to pay Windfall Tax treated the charges to their profit and loss accounts in respect of Windfall Tax as exceptional items—that is to say, items which derived from events or transactions that fell within the ordinary activities of the reporting entity and which needed to be disclosed by virtue of their size or incidence for the financial statements to give a true and fair view.

4.10 No company which was liable to pay Windfall Tax suffered an average rate of Windfall Tax in excess of 100% of its profit for its initial period such that the Windfall Tax was levied on the realised profits of these companies for their initial periods. In other words, none of the companies which were chargeable to Windfall Tax had a liability to Windfall Tax which exceeded its total profit for its initial period.

SECTION 5

My calculations of the Windfall Tax liabilities of all of the Regional Electricity Companies

5.1 Based upon my understanding of the Windfall Tax (which I have summarized in Appendix 2 to this report), I have recalculated the liabilities to Windfall Tax of all the UK's Regional Electricity Companies. All twelve of the UK's Regional Electricity Companies were privatised on 11 December 1990 and all of these companies, together with all other privatised utilities which were subjected to economic regulations as part of the privatisation process, were chargeable to the Windfall Tax.

5.2 In performing my calculations I have determined the amount of the total profit for the initial period of each of the twelve Regional Electricity Companies by reference to their audited financial statements which I obtained from the UK's Registrar of companies.

5.3 I obtained directly from Ofgem (the current statutory regulator of the electricity and gas markets in the UK) details of the number of shares offered by each Regional Electricity Company at the time of its privatisation. The institutional offer price at privatisation of each of the twelve Regional Electricity Companies was £2.40 per share and this too has been confirmed to me directly by Ofgem.

5.4 My calculations are set out in Appendix 3 to this report and are summarised in the table below.

Company Name	Windfall Tax (£ Millions)	Windfall Tax per Financial Statements (£ millions.)	Variance (£ millions)
East Midlands Electricity plc	£ 95.8	£ 95.8	£ 0.0
London Electricity plc	£ 140.0	£ 140.0	£0.0
Manweb plc	£ 96.8	£ 97.0	-£ 0.2
Midlands Electricity plc	£ 134.2	£ 134.2	£ 0.0
Northern Electric plc	£ 118.3	£ 118.3	£ 0.0
NORWEB plc	£ 155.2	£ 155.2	£ 0.0
SEEBOARD plc	£ 109.4	£ 109.5	- £ 0.1
South Wales Electricity plc	£ 89.8	£ 89.6	£ 0.2

South Western Electricity plc	£ 90.4	£ 90.4	£ 0.0
Southern Electric plc	£ 164.0	£ 164.0	£ 0.0
Yorkshire Electricity Group plc	£ 133.5	£ 133.6	- £ 0.1
Eastern Electricity plc	£ 111.6	£ 111.6	£ 0.0

5.5 It can be seen that my calculations of the Regional Electricity Companies' Windfall Tax liabilities are identical, or virtually identical, to the liabilities reported in their 1997 or 1998 financial statements.

5.6 In section 9 of this report I explain the accounting treatment adopted by SWEB to report its liability to Windfall Tax in its financial statements for the years ended 31 March 1997 and 31 March 1998, and I also explain the significance of the auditors' opinions on those financial statements.

5.7 In section 10 I explain how all of the other privatised companies which were chargeable to the Windfall Tax reflected their liabilities to Windfall Tax in their financial statements.

SECTION 6

The UK's financial reporting requirements in the 1990s

6.1 As I explain in Appendix 2 of this report, paragraph 5 of Schedule 1 to the Finance (No.2) Act 1997 makes reference to various parts of the Companies Act 1985, in particular to Sections 226 (individual company accounts), 227 (group accounts) and Schedule 4 (statutory format).

6.2 In this section of my report I will explain the statutory framework which governed companies' financial reporting in the UK in the 1990s and I will explain those parts of the legislation which are referred to in paragraph 5 of Schedule 1 to the Finance (No.2) Act 1997.

6.3 The Companies Act 1985 contained the statutory legal requirements which governed financial reporting by UK companies although by the 1990s some sections of the Companies Act 1985 had been modified by the provisions of the Companies Act 1989. In this section, I will take into account the modifications made by the Companies Act 1989 to any provisions of the Companies Act 1985 which are relevant to the statutory framework which governed companies' financial reporting in the 1990s.

6.4 I will include in this section only those aspects of the statutory legal requirements for financial reporting which were applicable to the companies that were chargeable to the Windfall Tax. For example, the legislation makes special provisions for financial reporting by banks and

insurance companies, and for small and medium sized companies, none of which is relevant to the companies that were chargeable to the Windfall Tax.

6.5 The legislation in the UK used the word "accounts" to refer to a company's financial statements. For consistency with the other sections of this report, and to avoid any opportunity for confusion with accounts that appear in companies' general ledgers for example, I will use the expression financial statements throughout.

6.6 Sections 226 and 227 of the Companies Act are substantially identical to one another except Section 226 deals with the preparation of financial statements of individual companies which do not have subsidiaries, and Section 227 deals with the preparation of consolidated financial statements for companies which have subsidiaries.

Section 226—companies without subsidiaries

6.7 Subsection 1 imposes a duty on the directors of every company to prepare for every financial year a balance sheet of the company as at the last day of its financial year and a profit and loss account. A company's profit and loss account in the UK is substantially similar to a company's earnings statement in the United States.

6.8 Subsection 2 requires that the company's balance sheet must give a true and fair view of

the state of the company's affairs as at the end of its financial year, and that its profit and loss account must give a true and fair view of the company's profit or loss for the financial year.

6.9 The concept of true and fair is fundamental to the integrity and reliability of corporate financial reporting in the UK, and I explain this concept at paragraphs 6.40 to 6.42 below.

6.10 Subsection 3 requires that the financial statements of a company must comply with the provisions of Schedule 4 as to the form and content of the balance sheet, the profit and loss account and the additional information to be disclosed in the notes to the financial statements. I explain the principal provisions of Schedule 4 at paragraphs 6.22 to 6.39 below.

6.11 Subsection 4 reinforces the fundamental principle that a company's financial statements must give a true and fair view by requiring that, where compliance with the disclosure requirements of the Companies Act 1985, would not be sufficient for the company's financial statements to give a true and fair view, the necessary additional information must be disclosed in those financial statements.

6.12 Subsection 5 further reinforces the fundamental principle that a company's financial statements must give a true and fair view by requiring that, where in special circumstances compliance with the provisions of the Companies Act 1985 is inconsistent with the requirement that a company's financial statements give a true and

fair view, the directors must depart from that provision or those provisions to the extent necessary for the company's financial statements to give a true and fair view, and the details of the departure(s) must be disclosed in the notes to the company's financial statements. This requirement of subsection 5 is referred to as the "true and fair override".

Section 227—companies with subsidiaries

6.13 As I explained in paragraph 6.6 above, the provisions of this section are substantially the same as those of Section 226 except that Section 227 applies to parent companies (i.e. companies with one or more subsidiaries).

6.14 Subsection 1 explains that, if a company is a parent company at the end of its financial year its directors must prepare group financial statements as well as individual financial statements for the parent company itself. It also requires that the group financial statements are consolidated financial statements. Consolidated financial statements are the financial statements of a group of companies which present the balance sheet of the group and the profit and loss account of the group in a manner which gives a true and fair view so far as concerns the shareholders of the parent company.

6.15 This means that such things as the parent company's investments in its subsidiaries and balances of indebtedness between group companies are eliminated by means of

consolidation adjustments so as to portray the financial performance and financial condition of the group as a whole from the viewpoint of the parent company's shareholders. In these respects, a set of consolidated financial statements in the UK is designed to serve the same purpose as a set of consolidated financial statements in the United States.

6.16 Whereas Section 226 requires that the financial statements of an individual company must comply with Schedule 4 of the Companies Act 1985 as to the form and content of the financial statements, subsection 4 of Section 227 requires that consolidated financial statements must comply with the requirements of Schedule 4A to the Companies Act 1985.

6.17 Section 227 places the same importance as Section 226 on the need for consolidated financial statements to give a true and fair view. Subsections 3, 5 and 6 of Section 227 are the same as those of Section 226 (which I have described above) except that they apply to consolidated financial statements rather than to the financial statements of an individual company.

Accounting standards

6.18 Section 256 was inserted into the Companies Act 1985 by means of one of the modifications introduced by the Companies Act 1989 which came into force on 1 April 1990. Section 256 gives statutory recognition to accounting standards. It explains that the term "accounting

standards" means statements of standard accounting practice issued by such body or bodies as may be prescribed by regulations. I will explain in the following section of this report the authority of accounting standards in the UK and I will explain the salient features of those which were relevant to disclosures in companies' financial statements in connection with the Windfall Tax.

The form and content of financial statements

6.19 Principally for the purpose of assisting meaningful comparisons to be made between the financial statements of one company and another, the Companies Act 1985 is highly prescriptive as to the format in which financial statements are permitted to be presented and about the content of financial statements.

6.20 Schedule 4 to the Companies Act 1985 specifies the form and content of the financial statements of an individual company and Schedule 4A specifies the form and content of the consolidated financial statements of a parent company. Schedule 4A does not repeat requirements which are set out in Schedule 4, but instead Schedule 4A modifies the requirements set out in Schedule 4 so as to make them applicable to consolidated financial statements rather than to the financial statements of an individual company.

6.21 For the purposes of describing the principal requirements of Schedules 4 and 4A, I will describe the requirements of Schedule 4.

Required formats for financial statements

6.22 Paragraph 1 of Schedule 4 requires that every balance sheet and every profit and loss account of a company must show the items listed in one of two prescribed balance sheet formats and in one of four prescribed profit and loss account formats.

6.23 Paragraph 2 requires that once a particular format has been selected it should be consistently used from one year to the next unless there are special reasons for a change of format in which case the reasons for the change must be explained in the company's financial statements.

6.24 Paragraph 3 permits disclosure in greater detail than is required by the chosen format and it permits an item specified by the chosen format not to be disclosed only if there is no amount to be reported in respect of that item. It is a requirement that every profit and loss account must show the amount of the company's profit or loss on ordinary activities before tax.

6.25 Paragraph 4 requires comparative figures to be disclosed for the preceding financial year. Paragraph 5 prohibits items representing assets or income from being offset against items representing liabilities or expenditure, or vice versa.

6.26 Simply for giving readers of this report an idea of one of the permitted formats for a company's profit and loss account, I set out below Format 1 as it appears in Section B of Schedule 4 to the Companies Act 1985.

Turnover		xxx
Cost of sales		(xxx)
Gross profit (or loss)		xxx
Distribution costs	(xxx)	
Administrative expenses	(xxx)	(xxx)
Other operating income		xxx
Income from shares in group undertakings	xxx	
Income from participating interests	xxx	
Income from other fixed asset investments	xxx	
Other interest receivable and similar income	xxx	
Amounts written off investments	(xxx)	xxx
Interest payable and similar charges		(xxx)
Profit (or loss) on ordinary activities before tax		xxx
Tax on profit (or loss) on ordinary activities		(xxx)
Extraordinary income	xxx	
Extraordinary charges	(xxx)	

Extraordinary profit or loss	(xxx)	xxx
Other taxes not shown under the above items		(xxx)
Profit (or loss)for the financial year		xxx

6.27 The total profits for the company's initial period for the purpose of calculating its liability to the Windfall Tax was the sum of the amounts of the company's *profit for the financial year* as disclosed by the financial statements of the company. This measure of the company's profitability is the amount shown by the last line in the profit and loss account set out above.

Accounting principles

6.28 Paragraphs 10 to 15 of Schedule 4 to the Companies Act 1985 set out the accounting principles which must be applied in the preparation of a company's financial statements.

6.29 Paragraph 10 states that financial statements must be prepared on the presumption that the company is carrying on business as a going concern. In other words, unless there are reasons to indicate that the company will be unable to continue in operation for the foreseeable future (foreseeability for this purpose is conventionally taken to mean the forthcoming year), its financial statements must be prepared on the assumption that it will continue in operational existence. This means, for example, that machinery used in a company's operations would be carried in its balance sheet at its historic cost less

depreciation (i.e. amortisation) rather than at the net realisable value (i.e. net selling price) of the second-hand machinery.

6.30 Paragraph 11 requires that the accounting policies selected by a company must be consistently applied from one year to the next.

6.31 Paragraph 12 requires that the amount at which any item is stated in a company's financial statements must be determined on a prudent basis. In particular, paragraph 12 requires that:

- *only profits realised at the balance sheet date shall be included in the profit and loss account, and*
- *all liabilities and losses which have arisen or are likely to arise in respect of the financial year to which the* [financial statements] *relate or a previous financial year shall be taken into account, including those which only become apparent between the balance sheet date and the date on which the* [financial statements] *are signed on behalf of the board of directors in pursuance of Section* 233 *of this Act.*

6.32 This paragraph of Schedule 4 to the Companies Act 1985 is important because it requires that the profit and loss accounts of all UK companies prepared in accordance with Schedule 4 must only include profits which are realised at the balance sheet date. It is not permitted to include unrealised profits in the profit and loss account.

6.33 Paragraph 13 requires that the financial statements of UK companies must be prepared

in accordance with the accruals concept by stating that *all income and charges relating to the financial year to which the* [financial statements] *relate shall be taken into account, without regard to the date of receipt or payment.*

6.34 Paragraph 14 states that, in determining the aggregate amount of any item to be disclosed in a company's financial statements, the amount of each individual asset or liability must be determined separately. In other words, it is not permitted to offset the amounts of assets and the amounts of liabilities within individual items that are reported in a company's financial statements.

6.35 Paragraph 15 explains that, if there are special reasons for departing from these accounting principles when preparing a company's financial statements, the directors may apply different accounting principles—but the particulars of the departure (which would include the financial effect of the departure) and the reasons for it must be disclosed in the company's financial statements.

Historical cost accounting rules

6.36 Paragraphs 17 to 28 of Schedule 4 to the Companies Act 1985 explain the rules that must be followed by the directors of UK companies preparing financial statements under the historical cost convention. The alternative accounting rules which may be adopted by directors of UK companies in the preparation of companies' financial statements are described in

paragraphs 31 to 34. These rules principally permit certain assets to be reported in a company's balance sheet at market value or current cost. In circumstances where the alternative accounting rules apply, additional information is required by paragraph 33 to be disclosed in the company's financial statements and this additional information includes disclosure of historical cost amounts.

Disclosures to be made in the notes to a company's financial statements

6.37 Paragraphs 35 to 58 of Schedule 4 to the Companies Act 1985 explain the disclosures which must be made in the notes to a company's financial statements. Only two of these required disclosures are worthy of mention in the context of this case.

6.38 First, paragraph 36 requires that the accounting policies adopted by a company for determining the amounts included in its financial statements must be disclosed in the notes to its financial statements.

6.39 Second, paragraph 54(2) requires disclosure of any special circumstances which affect a company's liability in respect of tax.

True and fair

6.40 During the 1990s the most authoritative statements as to the meaning of "true and fair" was the joint legal opinion obtained by the Accounting Standards Committee from Lord Hoffmann and Dame Mary Arden in 1983. The

title of this joint opinion was *"Legal Opinion obtained by the Accounting Standards Committee of True and Fair View, with particular reference to the role of Accounting Standards"*.

6.41 The extracts below illustrate that the concept of "true and fair" is not capable of rigid definition because it is a dynamic concept which evolves as accounting and financial reporting practices evolve. These extracts also illustrate the close proximity between Accounting Standards and the concept of "true and fair".

[An Accounting Standard] *is ... a declaration by the Accounting Standards Committee, on behalf of its constituent professional bodies, that save in exceptional circumstances* [financial statements] *which do not comply with the standard will not give a true and fair view.* (paragraph 2).

"True and fair view" is ... a legal concept and the question of whether company [financial statements] *comply ... can be authoritatively decided by a court* (paragraph 4).

The information contained in [financial statements] *must be accurate and comprehensive (to mention two of the most obvious elements which contribute to a true and fair view) to within acceptable limits* (paragraph 7).

[Financial statements] *will not be true and fair unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed* (paragraph 8).

... the courts will treat compliance with accepted accounting principles as prima facie evidence that the [financial statements] *are true and fair. Equally, deviation from accepted principles will be prima facie evidence that they are not* (paragraph 9).

... the value of [an Accounting Standard] *to a court which has to decide whether* [financial statements] *are true and fair is two-fold. First, it represents an important statement of professional opinion about the standards which readers may reasonably expect* in [financial statements] *which are intended to give a true and fair view ... Secondly, because accountants are professionally obliged to comply with* [an Accounting Standard], *it creates in the readers an expectation that the* [financial statements] *will be* in *conformity with the prescribed standards. This is* in *itself a reason why* [financial statements] *which depart from the standard without adequate justification or explanation may be held not to be true and fair* (paragraph 10).

The courts are of course not bound by [an Accounting Standard]. *A court may say that* [financial statements] *which ignore them are nevertheless true and fair. But the immediate effect of* [an Accounting Standard] is *to strengthen the likelihood that a court will hold that compliance with the prescribed standard is necessary for the* [financial statements] *to give a true and fair view* (paragraph 14).

6.42 In summary, unless exceptional circumstances prevail such the "true and fair override" is legitimately applicable, financial statements which do not comply with Accounting Standards are most unlikely to give a true and fair view.

SECTION 7

The UK's accounting and financial reporting standards in the 1990s in so far as these were relevant to the Windfall Tax

7.1 As far as SWEB is concerned, there are two periods during the 1990s which are relevant to the Windfall Tax, and this is also the case for all of the other regional electricity companies (which were privatised simultaneously) and to most of the other companies to which the Windfall Tax was applicable:

- first, the early 1990s when most of the companies to which the Windfall Tax was applicable prepared their financial statements upon which their liabilities to Windfall Tax were based (in the case of SWEB, this period consisted of its four financial years ended on 31 March 1992, 1993, 1994 and 1995—see Appendix 2) and,
- second, the years 1997 and 1998 when those companies to which the Windfall Tax was applicable prepared their financial statements in which their liabilities to the Windfall Tax were reflected.

7.2 British Telecommunications plc and British Gas plc were privatised in the mid 1980s such that

the accounting and financial reporting standards which prevailed in the late 1980s would have been applicable to the time during which they prepared their financial statements upon which their liabilities to the Windfall Tax were based.

7.3 In this section of my report I describe the accounting and financial reporting standards in the 1990s in so far as these are relevant to the Windfall Tax. It should be noted that there were no significant changes to the relevant accounting and financial reporting standards which prevailed in the second half of the 1980s (which governed the preparation of the financial statements of British Telecommunications plc and British Gas plc upon which their liabilities to the Windfall Tax were based) and those which prevailed in the early 1990s (which governed the preparation of the financial statements of later privatized companies such as SWEB upon which their liabilities to the Windfall Tax were based).

The authoritative nature of accounting standards

7.4 I explained at paragraph 6.18 above that, following the enactment of the Companies Act 1989 (the provisions of which came into effect on 1 April 1990), Section 256 of the Companies Act 1985 gave statutory recognition to accounting standards.

7.5 Except in circumstances where the *true and fair override* applied (see paragraph 6.42 above), this statutory recognition meant that failure to

comply with the requirements of an accounting standard represented a failure to comply with the requirements of the Sections 226 and 227 of the Companies Act 1985 that the financial statements and the consolidated financial statements of UK companies must give a true and fair view (see paragraphs 6.40 to 6.42 above respectively).

7.6 The authority of accounting standards was reinforced in the Foreword to Accounting Standards which was issued by the UK's Accounting Standards Board (which was responsible for developing accounting standards in the UK in the 1990s). Paragraph 16 of the Foreword to Accounting Standards explained that:

Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

7.7 The inclusion in the paragraph to the word "normally" was intended only to accommodate circumstances in which the *true and fair override* may be applicable. Because such circumstances in my experience are extremely rare (in fact, I have not once encountered such a circumstance during the whole of my professional career), this paragraph within the Foreword to Accounting Standards may be safely interpreted as meaning that failure to

comply with accounting standards will result in a company's financial statements failing to give a true and fair view.

7.8 In April 1993 a leading barrister in the UK named Mary Arden QC gave an Opinion on the relationship between accounting standards and the requirements in Sections 226 and 227 of the Companies Act 1985 that financial statements and consolidated financial statements give a true and fair view. The final sentence of this Opinion further reinforces the authoritative nature of accounting standards in the UK:

Just as a custom which is upheld by the courts may properly be regarded as a source of law, so too, in my view, does an accounting standard which the court holds must be complied with to meet the true and fair requirement become, in cases where it is applicable, a source of law in itself in the widest sense of that term.

7.9 There can be no doubt that accounting standards are authoritative to the extent that failure to comply with their requirements is highly likely to breach the true and fair requirement of the Companies Act 1985. In other words, absent circumstances to which the true and fair override applies, compliance with accounting standards is mandatory.

<u>The fundamental accounting concepts</u>

7.10 I explained in paragraphs 6.28 to 6.35 above the accounting principles that are required by the Companies Act 1985 to be applied in the

preparation of the financial statements of UK companies.

7.11 Statement of Standard Accounting Practice No. 2 ("SSAP2") was issued in 1971. In addition to requiring that the companies' financial statements disclose clearly the accounting policies that have been adopted in the preparation of those financial statements, it described the four fundamental accounting concepts (i.e. the broad basic assumptions that underlie companies' financial statements) with which companies' accounting policies must comply. These four fundamental accounting concepts are as follows:

The "going concern" concept

The enterprise will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and the balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation.

The "accruals" concept

Revenue and costs are accrued (that is, recognised as they are earned or incurred, not as money is received and paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate—provided that where the accruals concept is inconsistent with the "prudence" concept, the latter prevails.

The "consistency" concept

There is consistency of accounting treatment of like items within each accounting period and from one period to the next.

The "prudence" concept

Revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty; provision is made for all known liabilities (expenses and losses) whether the amount of these is known with certainty or is a best estimate in the light of the information available.

7.12 It will be noted that the definitions within SSAP2 of both the accruals concept and the prudence concept commence with the word *"Revenue"*. The word *"Revenue"* is no different in meaning from the word *"turnover"*—this being the word which Schedule 4 of the Companies Act 1985 requires to be used in companies' financial statements to describe *"revenue"* (see paragraph 6.26 above).

7.13 The fundamental accounting concepts are important in the context of financial reporting in the UK in many respects. For example, if the directors of a company were to use accounting policies for the preparation of a company's financial statements which were inconsistent with the fundamental accounting concepts, it is likely that these financial statements would fail

to comply with the legal requirement that company's financial statements give a true and fair view. They are also important in so far as it must be assured that only realized profits are included in a company's profit and loss account as required by paragraph 12 of Schedule 4 to the Companies Act 1985 (see paragraph 6.32 above).

Realised profits

7.14 The Council of the Institute of Chartered Accountants in England and Wales (in association with the Institute of Chartered Accountants of Scotland, the Institute of Chartered Accountants in Ireland, the Association of Certified Accountants, the Institute of Cost and Management Accountants and the Chartered Institute of Public Finance and Accountancy) published a statement of guidance on the determination of realised profits in the context of the requirements of UK law. This statement was initially issued in September 1982 but was amended to address the requirements of the Companies Act 1985.

7.15 Five extracts from this statement of guidance are relevant and these are reproduced below:

In determining whether a profit is realised, particular regard should be had to the statutory accounting principles at paragraphs 12 *and* 13 *of Schedule* 4 [to the Companies Act 1985], *and to the parallel fundamental accounting concepts of "prudence" and "accruals" as set out in SSAP2.*

[Within the definition of the "prudence" concept (see paragraph 7.11 above)] *the phrases "ultimate cash realisation" and "assessed with reasonable certainty" are intended to clarify the extent to which a profit can be said to be "realised" under the prudence concept in circumstances other than where the profit has already been realised in the form of cash. "Reasonable certainty" is the limiting factor.*

A profit which is required by statements of standard accounting practice to be recognised in the profit and loss account should normally be treated as a realised profit, unless the SSAP specifically indicates that it should be treated as unrealised.

... a profit will normally be a realised profit if the accounting policy adopted is consistent with paragraphs 12 *and* 13 *of Schedule* 4 [to the Companies Act *1985] and with the accruals and prudence concepts set out in SSAP2.*

Where [in special circumstances] *unrealised profits are ... recognised in the profit and loss account, particulars of this departure from the statutory accounting principle, the reasons for it and its effect are required to be given in a note to the* [financial statements].

7.16 In summary, all profits disclosed by UK companies' profit and loss accounts which have been prepared in accordance with Schedule 4 of the Companies Act 1985 are realised profits unless there is a note to the financial statements

explaining that unrealised profits have been included.

Reporting financial performance

7.17 Financial Reporting Standard No.3 ("FRS3") became effective for accounting periods which ended on or after 22 June 1993. It introduced changes to the format of companies' profit and loss accounts (principally to require the separate disclosure of profits derived from ongoing operations and discontinued operations) and to highlight other important components of companies' financial performance. There are three aspects of this accounting standard that are potentially relevant to this case—the definitions and disclosure requirements of *exceptional items* and *extraordinary items* and the disclosures that are required to be made in connection with special circumstances which affect a company's tax charge.

7.18 *Exceptional items* are defined as: *Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individually or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view.*

7.19 FRS3 requires that all exceptional items should be credited or charged in arriving at a company's profit or loss on ordinary activities by inclusion under the statutory format headings to which they relate. This accounting standard also requires that the amount of each exceptional

item should be disclosed separately in the notes to the financial statements or on the face of the profit and loss account if that degree of prominence is necessary in order for the financial statements to give a true and fair view.

7.20 *Extraordinary items* are defined as:

Material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur. They do not include exceptional items nor do they include prior period items merely because they relate to a prior period.

7.21 FRS3 requires that any extraordinary profit or loss should be shown separately on the face of the profit and loss account after the profit or loss on ordinary activities after tax but before deducting dividends. The amount of each extraordinary item should be shown individually either on the face of the profit and loss account or in a note to the financial statements and an adequate description of each extraordinary item should be given to enable its nature to be understood .

7.22 FRS3 also specifies the disclosures that must be made in a company's financial statements in connection with tax. Paragraph 23 states:

Any special circumstances that affect the overall tax charge or credit for the period, or that may affect those of future periods, should be disclosed by way of note to the profit and loss account and

their individual effects quantified ... The effects of a fundamental change in the basis of taxation should be included in the tax charge or credit for the period and separately disclosed on the face of the profit and loss account.

7.23 This disclosure requirement was clearly applicable to those companies which were chargeable to the Windfall Tax since the enactment of the Finance (No.2) Act 1997 gave rise to a special circumstance which affected the overall tax charge of those companies.

Post balance sheet events

7.24 Statement of Standard Accounting Practice No.17 was issued in August 1980 and it is entitled "accounting for post-balance sheet events." It describes post balance sheet events as being those events, both favourable and unfavourable, which occur between the balance sheet date and the date on which a company's financial statements are approved by its board of directors. It explains that events occurring after the balance sheet date need to be classified into two categories—"adjusting events" and "non-adjusting events".

7.25 Adjusting events are events which provide additional evidence of conditions which existed at the balance sheet date. They require changes in the amounts to be included in the financial statements. Examples of adjusting events are given in the appendix to this accounting standard, and they include such events as the renegotiation of amounts owing by customers

and the insolvency of a customer which would require an adjustment to the receivables balance reported in a company's financial statements.

7.26 Non-adjusting events are post balance sheet events which concern conditions which did not exist at the balance sheet date. Examples of non-adjusting events include losses of property resulting, for example, from a fire, changes in foreign exchange rates, and Government action such as nationalisation.

7.27 This accounting standard requires a post balance sheet event to be disclosed in a company's financial statements where it is a non-adjusting event of such materiality that its non-disclosure would affect the ability of users of the financial statements to reach a proper understanding of the company's financial position, or where it is the reversal or maturity after the year-end of a transaction entered into before the year-end the substance of which was primarily to alter the appearance of the company's balance sheet. In such circumstances the accounting standard requires disclosure of the nature of the event and an estimate of the financial effect or, where appropriate, a statement that it is not practicable to make such an estimate.

SECTION 8

The duties of the auditors of UK companies in the 1990s

8.1 With the exception of dormant companies and small companies, all UK companies are required

by Section 384 of the Companies Act 1985 to appoint auditors.

8.2 Section 235 of the Companies Act 1985 requires a company's auditors to make a report on the company's financial statements giving their opinion on whether the financial statements have been properly prepared in accordance with the provisions of the Companies Act 1985 and whether the financial statements give a true and fair view.

8.3 Section 237 of the Companies Act 1985 imposes a number of duties on a company's auditors. For example, if the auditors are of the opinion that proper accounting records have not been maintained by the company, or if the auditors fail to obtain all the information and explanations that they consider to be necessary for the purpose of their audit, they are required to state these matters in their report.

8.4 In the 1990s the Auditing Practices Board was responsible for the development of auditing standards in the UK. These were authoritative statements with which all auditors were required to comply, and auditors were required to have effective procedures in place to ensure compliance with the auditing standards.

8.5 Statement of Auditing Standard 600 is entitled *Auditors' Reports on Financial Statements*. This auditing standard explains the action required to be taken by auditors when they disagree with the accounting treatment adopted by the directors in the preparation of a company's

financial statements or when they disagree with the disclosures made in those financial statements. The relevant passage of Statement of Auditing Standard 600 reads as follows:

Where the auditors disagree with the accounting treatment or disclosure of a matter in the financial statements, and in the auditors' opinion the effect of that disagreement is material to the financial statements:

(a) the auditors should include in the opinion section of their report:

i. a description of all substantive factors giving rise to the disagreement;

ii. their implications for the financial statements;

iii. whenever practicable, a quantification of the effect on the financial statements;

(b) when the auditors conclude that the effect of the matter giving rise to the disagreement is so material or pervasive that the financial statements are seriously misleading, they should issue an adverse opinion;

(c) in the case of other material disagreements, the auditors should issue a qualified opinion indicating that it is expressed except for the effects of the matter giving rise to the disagreement.

8.6 As a result of Statement of Auditing Standard 600, auditors would only issue an unqualified audit report if they were satisfied that the company's financial statements:

- are free of material errors;
- disclose all information required to be disclosed by the Companies Act 1985 and all applicable Accounting Standards;
- have been prepared using suitable accounting policies which are compliant with all applicable Accounting Standards and which are fully consistent with the four fundamental accounting concepts, and
- give a true and fair view of the company's financial performance and financial condition.

SECTION 9

The audited financial statements of SWEB for the years ended 31 March 1997 and 31 March 1998

9.1 Copies of the audited financial statements of SWEB for the years ended 31 March 1997 and 31 March 1998 appear at Appendix 4 and Appendix 5 respectively of this report.

SWEB's financial statements for the year ended 31 March 1997

9.2 SWEB's financial statements for the year ended 31 March 1997 were approved by its board of directors on 30 October 1997 (page 7 of Appendix 4). By this time the Finance (No.2) Act 1997 had been enacted and the Windfall Tax had been introduced.

9.3 The directors of SWEB took the view that the introduction of the Windfall Tax was a non-adjusting post balance sheet event. However,

because SWEB's liability to the Windfall Tax was material to its financial statements, this non-adjusting post balance sheet event was disclosed in the notes to the financial statements in accordance with the requirements of Statement of Standard Accounting Practice No. 17 (see paragraphs 7.24 to 7.27 above).

9.4 Note 20 to SWEB's financial statements for the year ended 31 March 1997 is entitled "subsequent events" and the first paragraph of this note reads as follows (page 20 of Appendix 4):

On 1 May 1997 *a new Labour government was elected. On* 2 *July* 1997, *the Labour government presented its first budget which includes a "one-off windfall levy on the excess profits of the privatised utilities". Based on the method determined by which the government will calculate the levy, the Company estimates its liability to be approximately £91m. The levy is payable in two equal instalments on or before* 1 *December* 1997 *and* 1 *December 1998. The budget received Royal assent, and thus became effective, on* 31 *July 1997.*

9.5 The financial effect of the introduction of the Windfall Tax was also referred to in the directors' report contained within SWEB's financial statements for the year ended 31 March 1997 (page 3 of Appendix 4) as follows:

Subsequent events

The imposition by the new Labour government of a "one-off windfall levy on the excess profits of

privatised utilities" will severely impact earnings in the year ended 31 *March* 1998 *and the additional funding required will reduce earnings in future periods...*

9.6 The report of SWEB's auditors, Arthur Andersen, on SWEB's financial statements for the year ended 31 March 1997 appears on page 5 of Appendix 4. This report explains that SWEB's financial statements have been prepared under the historical cost convention (see paragraph 6.36 above) and that the company's directors are responsible for the preparation of the company's financial statements. The auditors' report explains that Arthur Andersen conducted their audit in accordance with Auditing Standards issued by the Auditing Practices Board, which would have included Statement of Auditing Standard 600 (see paragraph 8.5 above).

9.7 The auditors' opinion is unqualified. It reads as follows:

In our opinion the [financial statements] *give a true and fair view of the Company's state of affairs at 31 March 1997 and of its profit for the year then ended and have been properly prepared in accordance with the Companies Act* 1985.

9.8 For the reasons explained at paragraph 8.6 above, Arthur Andersen issued an unqualified audit report on SWEB's financial statements for the year ended 31 March 1997 because they

were satisfied that the company's financial statements:

- were free of material errors;
- disclosed all information required to be disclosed by the Companies Act 1985 and all applicable Accounting Standards;
- had been prepared using suitable accounting policies which are compliant with all applicable Accounting Standards and which are fully consistent with the four fundamental accounting concepts, and
- gave a true and fair view of the company's financial performance and financial condition.

9.9 In particular, for Arthur Andersen to have given an unqualified audit opinion on the financial statements of SWEB for the year ended 31 March 1997 it is my opinion that Arthur Andersen must have been satisfied with the disclosures made in those financial statements in connection with the Windfall Tax and its financial effect on SWEB. As these disclosures made reference to a *"one-off windfall levy on the excess profits of privatised utilities"*, Arthur Andersen must have been of the opinion that this wording accurately reflected the substance of the Windfall Tax.

<u>SWEB's financial statements for the year ended 31 March 1998</u>

9.10 A copy of SWEB' s financial statements for the year ended 31 March 1998 appears at Appendix 5. These were approved by SWEB's board of directors on 18 September 1998 (see page 7 of Appendix 5).

9.11 SWEB's profit and loss account for the year ended 31 March 1998 appears on page 6 of these financial statements and it includes a charge of £90.4 million in respect of SWEB's liability to the Windfall Tax. A footnote to this profit and loss account explains that *"The profits for* 1998 *and* 1997 *are comparable before the impact of the windfall levy of £90.4m charged in* 1998".

9.12 In compliance with the disclosure requirements of Financial Reporting Standard No.3 in respect of taxation (see paragraph 7.22 above), note 5 to SWEB's financial statements for the year ended 31 March 1998 explained the circumstances that had given rise to the company's liability to Windfall Tax as follows:

Windfall levy

The first budget of the Labour government had a significant impact on the profitability of the Company in 1998. *The Labour Party's election manifesto included the commitment to introduce "a one-off windfall levy on the excess profits of the privatised utilities", and on* 2 *July* 1997 *the government presented its first budget which included such a levy. Based up on the legislation, SWEB estimated its liability to be £90.4m. The levy is payable in two equal instalments. The first instalment was paid on* 1 *December* 1997 *and the second will be paid on or before* 1 *December 1998.*

9.13 Note 13 to SWEB' s financial statements for the year ended 31 March 1998 disclosed the breakdown of the company's creditors (i.e.

amounts payable) at 31 March 1998 (see page 16 of Appendix 5). Included in the breakdown of SWEB's creditors at 31 March 1998 was £45.2 million in respect of Windfall Tax payable by SWEB on or before 1 December 1998 .

9.14 The audit opinion of Arthur Andersen on SWEB's financial statements for the year ended 31 March 1998 appears on page 5 of Appendix 5. Arthur Andersen's audit opinion is unqualified. It reads as follows:

In our opinion the [financial statements] *give a true and fair view of the Company's state of affairs at* 31 *March* 1998 *and of its profit for the year then ended and have been properly prepared in accordance with the Companies Act* 1985.

9.15 For the reasons explained at paragraph 9.8 above, Arthur Andersen issued an unqualified audit report on SWEB's financial statements for the year ended 31 March 1998 because they were satisfied that the company's financial statements:

- were free of material errors;
- disclosed all information required to be disclosed by the Companies Act 1985 and all applicable Accounting Standards;
- had been prepared using suitable accounting policies which are compliant with all applicable Accounting Standards and which are fully consistent with the four fundamental accounting concepts, and

- gave a true and fair view of the company's financial performance and financial condition.

9.16 Again, for Arthur Andersen to have given an unqualified audit opinion on the financial statements of SWEB for the year ended 31 March 1998 it is my opinion that Arthur Andersen must have been satisfied with the disclosures made in those financial statements in connection with the Windfall Tax and its financial effect on SWEB. As these disclosures made reference to a *"one-off windfall levy on the excess profits of privatised utilities"*, Arthur Andersen must have been of the opinion that this wording accurately reflected the substance of the Windfall Tax .

SECTION 10

The accounting treatment for Windfall Tax liabilities used by all other companies to which the Windfall Tax applied

10.1 In this section I will describe the accounting treatment for Windfall Tax liabilities that was used by all of the other privatised companies to which the Windfall Tax applied. In particular, I will consider for each company:

- the accounting reference period in which that company's liability to Windfall Tax was recognised in its financial statements,
- the accounting treatment adopted for presenting the charge in respect of the Windfall Tax liability in the profit and loss account, and

- the opinion of the auditors on the financial statements in which the
- Windfall Tax liabilities were charged to the company's profit and loss account.

10.2 Page 1 of **Appendix 6** is a schedule listing all 32 privatised companies which were chargeable to Windfall Tax. For each of these companies this schedule shows:

- the accounting reference period in which the company charged its Windfall Tax liability to its profit and loss account,
- the amount charged to the profit and loss account in respect of the company's Windfall Tax liability,
- the accounting treatment used by the company to present its charge in respect of its Windfall Tax liability in its profit and loss account, and
- whether the auditors' opinion on those financial statements was qualified or unqualified.

10.3 Page 1 of Appendix 6 also refers to other documents exhibited within Appendix 6 including a copy of each company's profit and loss account and a copy of the auditors' opinion on the financial statements in which the company's liability to Windfall Tax was recognised.

10.4 It can be seen from page 1 of Appendix 6 that British Energy plc did not recognise any liability to Windfall Tax in its financial statements. My calculations at Appendix 7 show that, whilst

British Energy plc was chargeable to Windfall Tax because it was subjected to the imposition of economic regulation in connection with its privatisation, its profits in its initial period did not exceed by a factor of nine the product of the number of shares issued at privatisation multiplied by its institutional offer price at privatisation (see Appendix 2).

Accounting reference periods

10.5 The Finance (No.2) Act 1997 received Royal Assent, and hence became law in the UK, on 31 July 1997. Consequently, the liabilities of privatised companies to the Windfall Tax crystallised on 31 July 1997.

10.6 Accordingly, I would have expected all of the 31 privatised companies which were liable to pay Windfall Tax to have reported charges to their profit and loss accounts in respect of their liabilities to Windfall Tax in their accounting reference periods in which 31 July 1997 fell.

10.7 This was the accounting treatment adopted by SWEB as I described in the previous section of this report. SWEB recognised a charge in respect of its liability to Windfall Tax in its profit and loss account for the year ended 31 March 1998.

10.8 With one exception, all of the 30 other companies that were liable to Windfall Tax charged to their profit and loss accounts for the period in which 31 July 1997 fell amounts in respect of their liabilities to Windfall Tax.

10.9 The exception was London Electricity plc which charged its liability to Windfall Tax in its profit and loss account for the year ended 31 March 1997. These financial statements were approved by the board of directors of London Electricity plc on 28 July 1997.

10.10 At 31 March 1997 not only was there no liability on any privatised company to pay Windfall Tax (because the Finance (No.2) Act 1997 did not come into force until 31 July 1997) but there was no certainty that the Windfall Tax would be introduced at that time (because the election of the Labour government—which had proposed the introduction of an excess profits tax on privatised utility companies—did not happen until I May 1997). Furthermore, even on the day on which the board of directors of London Electricity plc approved the group's financial statements for the year ended 31 March 1997 (28 July 1997), the Finance (No.2) Act 1997 had not received Royal Assent.

10.11 Whilst in my opinion an amount of £140 million was material to the financial statements of London Electricity plc for the year ended 31 March 1997, the disclosures contained within these financial statements about the accounting treatment applied in respect of the company's liability to Windfall Tax could, in my opinion, have left readers of those financial statements in no doubt as to the treatment adopted. In my opinion, no reader of the financial statements of London Electricity plc's financial statements for

the year ended 31 March 1997 could have been misled.

The accounting treatments adopted for presenting the charges in respect of Windfall Tax liabilities in the companies' profit and loss accounts

10.12 As can be seen by page 1 of Appendix 6, the 31 companies that were liable to pay Windfall Tax used two different methods of presenting their charges to Windfall Tax in their profit and loss accounts. These two different methods involve the Windfall Tax charges being:

- separately disclosed as a component of the company's or the group's *tax on profit on ordinary activities*, or
- separately reported as a tax charge on the face of the profit and loss account after the line showing the company's or the group's *tax on profit on ordinary activities*.

10.13 I will discuss each of these accounting treatments in turn in the paragraphs which follow.

Separately disclosed as a component of the company's or the group's tax on ordinary activities

10.14 Of the 31 companies that were liable to pay Windfall Tax, 10 companies (including London Electricity plc) separately disclosed their charges in respect of Windfall Tax liabilities as a component of the company's or the group's *tax on profit on ordinary activities*.

10.15 By including their charges to Windfall Tax as a component of their taxes on ordinary activities, these 10 companies and groups portrayed their Windfall Tax liabilities in their financial statements as being tax liabilities which fell within the ordinary activities of the company or group.

10.16 By separately disclosing the charges in respect of Windfall Tax, these companies and groups treated these charges as being exceptional, items (see paragraph 7.18 above). Exceptional items are those which derive from events or transactions that fall within the ordinary activities of the reporting entity and which need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view.

Separately reported as a tax charge on the face of the profit and loss account after the line showing the company's or the group's tax on profit on ordinary activities

10.17 Of the 31 companies that were liable to pay Windfall Tax 21 companies (including SWEB—see section 9 of this report) separately disclosed their charges in respect of Windfall Tax liabilities as exceptional charges on the face of their profit and loss accounts after the line showing the company's or the group's *tax on profit on ordinary activities*.

10.18 By separately disclosing the charges in respect of Windfall Tax, these companies and groups treated these charges as being exceptional

items (see paragraph 7.18 above). As I explained in paragraph 10.16 above, exceptional items are those which derive from events or transactions that fall within the ordinary activities of the reporting entity and which need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view.

10.19 The fact that these 21 companies or groups did not include their charges to Windfall Tax as one of the components of their taxes on ordinary activities should not be interpreted as suggesting that the directors of these 21 companies viewed their Windfall Tax liabilities as though they fell outside the ordinary activities of the company or group.

10.20 If these 21 companies had viewed their Windfall Tax liabilities as though they fell outside the ordinary activities of the company or group, they would have treated their charges in respect of Windfall Tax liabilities as extraordinary items (see paragraph 7.20 above) in accordance with Financial Reporting Standard No.3.

10.21 Extraordinary items are material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur. They do not include exceptional items nor do they include prior period items merely because they relate to a prior period.

10.22 Not one of the 31 companies that was liable to pay Windfall Tax treated the charge to its profit and loss account in respect of Windfall Tax as an extraordinary item. In other words, for financial reporting purposes all 31 of these companies and groups treated their Windfall Tax liabilities as though they fell within the ordinary activities of the company or the group.

10.23 In summary, all 31 companies which were liable to pay Windfall Tax treated the charges to their profit and loss accounts in respect of Windfall Tax as exceptional items—those which derive from events or transactions that fall within the ordinary activities of the reporting entity and which need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view.

10.24 Of these 31 companies, 10 companies disclosed their charges in respect of their liabilities to Windfall Tax as a component of the company's or the group's tax on ordinary activities, and 21 disclosed their charges as a tax charge on the face of their profit and loss accounts after the line showing the company's or the group's tax on profit on ordinary activities.

10.25 As can be seen from page 1 of Appendix 6 to this report, not one of the opinions expressed by the auditors was qualified on the financial statements of the companies that were chargeable to the Windfall Tax for the financial reporting period in which 31 July 1997 fell (or, in the case of London Electricity plc, the year ended 31 March 1997).

10.26 In respect of British Energy plc which reported no liability to Windfall Tax, this demonstrates that its auditors were satisfied that British Energy plc had no liability to Windfall Tax.

10.27 For the reasons explained in paragraph 8.6 above, the auditors issued unqualified audit opinions on these financial statements because they were satisfied that the company's or the group's financial statements:

- were free of material errors;
- disclosed all information required to be disclosed by the companies Act 1985 and all applicable Accounting Standards;
- had been prepared using suitable accounting policies which are compliant with all applicable Accounting Standards and which are fully consistent with the four fundamental accounting concepts, and
- gave a true and fair view of the company's financial performance and financial condition .

SECTION 11

The marginal rates of Windfall Tax and the average rate of Windfall Tax suffered by Railtrack Group plc

11.1 I have been asked to explain how the marginal rates of Windfall Tax changed as the duration of a company's initial' period shortens, and to calculate the average rate of Windfall Tax suffered by Railtrack Group plc.

Marginal rates of Windfall Tax

11.2 In Appendix 8 I have analysed the Windfall Tax in mathematical terms and I have established that, in the usual circumstance in which a company's initial period was of four years' duration, the Windfall Tax was levied at a marginal rate of approximately 51.7% on the company's total profit for its initial period over a threshold amount—the threshold amount being 23% of the number of shares in issue at the time of the company's flotation multiplied by the highest fixed price per share on flotation.

11.3 I have also established that this marginal rate of Windfall Tax increases as the duration of a company's initial period shortens. In the hypothetical example of a company with an initial period of 365 days, I have calculated that the company would have faced a marginal rate of Windfall Tax of 207% on the company's total profit for its initial period over its threshold amount.

11.4 Whilst a company's marginal rate of Windfall Tax could hypothetically have exceeded 100%, this marginal rate of tax is applicable only to the company's profits in excess of its threshold amount (as described above), not to the company's total profits for its initial period.

<u>The average rate of Windfall Tax suffered by Railtrack Group plc</u>

11.5 British Energy plc was privatised on 15 July 1996 and, of the companies that were chargeable to Windfall Tax, it was the last company to be privatised such that it had the shortest initial

period. As I explained at paragraph 10.4 above, British Energy plc did not recognise any liability to Windfall Tax in its financial statements. My calculations at Appendix 7 show that British Energy plc's profits in its initial period did not exceed by a factor of nine the product of the number of shares issued at privatisation multiplied by its institutional offer price at privatisation. Consequently, British Energy plc was not liable to pay Windfall Tax.

11.6 The company with the second shortest initial period was Railtrack Group plc. This company was privatised on 20 May 1996 and had an initial period of 316 days' duration. Its total profit for its initial period was £252,800,000 and its liability to Windfall Tax was £155,939,807 (see Appendix 9). Consequently, Railtrack Group plc suffered an average rate of Windfall Tax of some 61.7%.

11.7 Because the average rate of Windfall Tax suffered by Railtrack Group plc was some 61.7%, the Windfall Tax was levied on the realised profits of Railtrack Group plc for its initial period.

11.8 Because all other companies which were liable to pay Windfall Tax had longer initial periods than Railtrack Group plc, they would have suffered Windfall Tax at a lower marginal rate than Railtrack Group plc. They would consequently have suffered a lower average rate of Windfall Tax than Railtrack Group plc.

11.9 No company which was liable to pay Windfall Tax suffered an average rate of Windfall Tax in excess of 100% of its profit for its initial period such that it may be said that the Windfall Tax was levied on the realised profits of these companies for their initial periods.

SECTION 12

My conclusions

12.1 The Finance (No.2) Act 1997 required that the financial statements of a company by reference to which its profit for its initial period would be determined must have been prepared in accordance with Sections 226 (individual company accounts) and 227 (group accounts) of the Companies Act 1985 (Appendix 2).

12.2 During the 1990s the fonn and content of UK companies' financial statements and consolidated financial statements were governed by Schedules 4 and 4A respectively to the Companies Act 1985 as modified by the Companies Act 1989. Paragraph 12 of Schedule 4 requires that the amount at which any item is stated in a company's financial statements must be determined on a prudent basis (paragraph 6.31). In particular, paragraph 12 requires that:

- *only profits realised at the balance sheet date shall be included in the profit and loss account, and*
- *all liabilities and losses which have arisen or are likely to arise in respect of the financial year to which the* [financial statements] *relate*

or a previous financial year shall be taken into account, including those which only become apparent between the balance sheet date and the date on which the [financial statements] *are signed on behalf of the board of directors in pursuance of Section 233 of this Act.*

12.3 This paragraph of Schedule 4 to the Companies Act 1985 is important because it requires that the profit and loss accounts of all UK companies prepared in accordance with Schedules 4 and 4A to the Companies Act 1985 must only include profits which are realised at the balance sheet date. It is not permitted to include unrealised profits in the profit and loss account (paragraph 6.32).

12.4 The authority of Accounting Standards was given statutory recognition by the Companies Act 1989 (paragraph 6.18). Statement of Standard Accounting Practice No.2 ("SSAP2") was issued in 1971 and remained in force throughout the 1990s. It described the four fundamental accounting concepts (i.e. the broad basic assumptions that underlie companies' financial statements) with which companies' accounting policies must comply (paragraph 7.11). Two of these four fundamental accounting concepts are the *accruals* concept and the *prudence* concept. These two concepts are defined by SSAP2 as follows:

The "accruals" concept

Revenue and costs are accrued (that is, recognised as they are earned or incurred, not as

money is received and paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate—provided that where the accruals concept is inconsistent with the "prudence" concept, the latter prevails.

The "prudence" concept

Revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty; provision is made for all known liabilities (expenses and losses) whether the amount of these is known with certainty or is a best estimate in the light of the information available.

12.5 The definitions of both the accruals concept and the prudence concept commence with the word "*Revenue*". The word "*Revenue*" is no different in meaning from the word "*turnover*"—this being the word which Schedule 4 of the Companies Act 1985 requires to be used in companies' financial statements to describe revenue (see paragraph 6.26 above). The words revenue and turnover are synonymous and have the same meaning as gross sales.

12.6 The accruals concept requires that revenues and costs are recognised as they are earned or incurred and matched with one another so far as their relationship can be established or

justifiably assumed. Consequently, amounts of profit shown by profit and loss accounts which have been prepared in accordance with the accruals concept are no different from amounts of net income—i.e. revenues less all associated costs .

12.7 The Council of the Institute of Chartered Accountants in England and Wales published a statement of guidance on the determination of realised profits in the context of the requirements of UK law (paragraphs 7.15 and 7.16). Five extracts from this statement of guidance are relevant:

In determining whether a profit is realised, particular regard should be had to the statutory accounting principles at paragraphs 12 and 13 of Schedule 4 [to the Companies Act 1985], *and to the parallel fundamental accounting concepts of "prudence" and "accruals" as set out in SSAP2.*

[Within the definition of the "prudence" concept (see paragraph 7.11 above)] *the phrases "ultimate cash realisation" and "assessed with reasonable certainty" are intended to clarify the extent to which a profit can be said to be "realised" under the prudence concept in circumstances other than where the profit has already been realised in the form of cash. "Reasonable certainty" is the limiting factor.*

A profit which is required by statements of standard accounting practice to be recognised in the profit and loss account should normally be

treated as a realised profit, unless the SSAP specifically indicates that it should be treated as unrealised.

... a profit will normally be a realised profit if the accounting policy adopted is consistent with paragraphs 12 and 13 of Schedule 4 [to the Companies Act 1985] *and with the accruals and prudence concepts set out in SSAP2.*

Where [in special circumstances] *unrealised profits are ... recognised in the profit and loss account, particulars of this departure from the statutory accounting principle, the reasons for it and its effect are required to be given in a note to the* [financial statements].

12.8 In the light of this authoritative statement of guidance, there can be no doubt that all profits disclosed by UK companies' profit and loss accounts are realised profits unless there is a note to the financial statements explaining that unrealised profits have been included (paragraph 7.16). None of the financial statements for the initial periods of privatised companies to which the Windfall Tax applied contained a note explaining that unrealised profits had been included in its profit and loss account. Consequently, the profits by reference to which companies' liabilities to Windfall Tax were assessed were realised profits.

12.9 Section 235 of the Companies Act 1985 requires a company's auditors to make a report on the company's financial statements giving their opinion on whether the financial statements

have been properly prepared in accordance with the provisions of the Companies Act 1985 and whether the financial statements give a true and fair view (paragraph 8.2).

12.10 As a result of Statement of Auditing Standard 600 (paragraph 8.6), auditors would only issue an unqualified audit report on a company's financial statements if they were satisfied that the company's financial statements:

- are free of material errors;
- disclose all information required to be disclosed by the Companies Act 1985 and all applicable Accounting Standards;
- have been prepared using suitable accounting policies which are compliant with all applicable Accounting Standards and which are fully consistent with the four fundamental accounting concepts, and
- give a true and fair view of the company's financial performance and financial condition.

12.11 SWEB charged £90.4 million to its profit and loss account for the year ended 31 March 1998 in respect of its liability to Windfall Tax (paragraph 9.11). In compliance with the disclosure requirements of Financial Reporting Standard No.3 in respect of taxation (paragraph 9.12), note 5 to SWEB's financial statements for the year ended 31 March 1998 explained the circumstances that had given rise to the company's liability to Windfall Tax as follows:

Windfall levy

The first budget of the Labour government had a significant impact on the profitability of the Company in 1998. The Labour Party's election manifesto included the commitment to introduce "a one-off windfall levy on the excess profits of the privatised utilities", and on 2 July 1997 the government presented its first budget which included such a levy. Based upon the legislation, SWEB estimated its liability to be £90.4m The levy is payable in two equal instalments. The first instalment was paid on 1 December 1997 and the second will be paid on or before 1 December 1998.

The audit opinion of Arthur Andersen on SWEB's financial statements for the year ended 31 March 1998 was unqualified (paragraph 9.14). Consequently, in my opinion Arthur Andersen would only have issued an unqualified audit opinion on SWEB's financial statements for the year ended 31 March 1998 if the auditors were satisfied that the company's financial statements:

- were free of material errors;
- disclosed all information required to be disclosed by the Companies Act 1985 and all applicable Accounting Standards; o
- had been prepared using suitable accounting policies which are compliant with all applicable Accounting Standards and which are fully consistent with the four fundamental accounting concepts, and

- gave a true and fair view of the company's financial performance and financial condition.

12.12 SWEB was one of 32 privatised companies which were chargeable to Windfall Tax (paragraph 10.2). One of these companies, British Energy plc (paragraph 10.4), did not recognise any liability to Windfall Tax in its financial statements because, whilst British Energy plc was chargeable to Windfall Tax because it was subjected to the imposition of economic regulation in connection with its privatisation, its profits in its initial period did not exceed by a factor of nine the product of the number of shares issued at privatisation multiplied by its institutional offer price at privatisation.

12.13 All of the 31 companies (including SWEB) that were liable to pay Windfall Tax treated the charges to their profit and loss accounts in respect of Windfall Tax as exceptional items—those which derive from events or transactions that fall within the ordinary activities of the reporting entity and which need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view (paragraph 10.23).

12.14 Extraordinary items are material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur (paragraph 7.20). None of the 31 companies that was liable to pay Windfall Tax treated the

charge to its profit and loss account in respect of Windfall Tax as an extraordinary item (paragraph 10.22). In other words, all 31 of these companies and groups treated their Windfall Tax liabilities as though they fell within the ordinary activities of the company or the group.

12.15 No company which was liable to pay Windfall Tax suffered an average rate of Windfall Tax in excess of 100% of its profit for its initial period such that it may be said that the Windfall Tax was levied on the realised profits of these companies for their initial periods (Appendix 8). In other words, none of the companies which were chargeable to Windfall Tax had a liability to Windfall Tax which exceeded its total profit for its initial period.

[Appendices omitted in printing this appendix]

EXHIBIT 142-P

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Report of Professor Edward L. Maydew
On Behalf of PPL Corporation and Subsidiaries

September 8, 2008

[Table of Contents omitted in printing this appendix]

I. Qualifications

1. My name is Edward Lyle Maydew. I am a chaired professor of accounting at the University of North Carolina; my formal title is the David E. Hoffman Distinguished Professor of Accounting. I also teach periodically at Cornell University as a visiting professor. Prior to my

current appointment, I was on the faculty of the University of Chicago.

2. My teaching and research focus on accounting, taxation, and often the intersection and interplay between the two. Much of my research involves quantitative analysis and frequently makes use of differences in accounting and tax rules across dimensions such as time, countries, and types of firms. I teach mainly in the MBA, Masters of Accounting, and PhD programs.

3. I received my PhD in 1993 from the University of Iowa and a bachelor's degree, majoring in accounting, from Iowa State University in 1987. During the time between my undergraduate degree and starting my PhD, I was employed by then Price Waterhouse & Co as a tax associate in Chicago.

4. I am co-author of Taxes and Business Strategy: A Planning Approach, (Pearson/Prentice Hall, 4th edition), which is a leading textbook for teaching tax strategy to MBAs.

5. I publish in the top academic journals in my field, including Journal of Accounting Research, Journal of Finance, Journal of Accounting and Economics, The Accounting Review, Journal of the American Taxation Association, Journal of Public Economics, and National Tax Journal.

6. I have served on the editorial boards of many of the top journals in my field, including Journal of Accounting and Economics, The Accounting Review, Journal of the American Taxation Association, and Review of Accounting Studies. I

have served as a Trustee of the American Taxation Association, the primary academic organization for accounting professors with research and teaching interests in taxation. I have also served on the Board of Directors of the National Tax Association, an organization that is composed mainly of economists but also includes accountants and attorneys.

7. I have received three national awards for research concerning the interaction of taxes and accounting. In 1994, I received the American Taxation Association / Price Waterhouse Doctoral Award for research from my PhD dissertation titled "Tax Induced Earnings Management by Firms with Net Operating Losses." In 1999, I received the American Taxation Association Outstanding Manuscript Award for research titled "Financial Reporting, Tax Costs, and Book Tax Conformity," and I received the award again in 2002 for research titled "Debt-Equity Hybrid Securities."

8. Much of my research involves quantitative analysis and frequently makes use of differences in accounting and tax rules across dimensions such as time, countries, and types of firms. For example, I have published research on the effects of changes in Germany's taxation of corporate capital gains. I have published two studies of changes in the value-relevance and information content of accounting earnings across time. I am currently conducting research on i) changes in the informativeness of accounting earnings across countries and over

time, ii) implications that increased book-tax conformity would have for multinationals, and iii) the effects of increased book-tax conformity on the informativeness of accounting earnings.

9. I am being compensated for my time at my standard rate of $650 per hour. To date I have invoiced a totals of $47,125 for my time in connection with this litigation. My compensation is not dependent on my conclusions or the outcome of this litigation.

II. Assignment

10. I was asked by counsel for PPL Corporation to provide an opinion as to whether the UK Windfall Tax is in the nature of a tax on net income as that term is generally used in the U.S.

III. Summary of Opinion

11. The U.K. Windfall Tax is a tax on realized income and is in substance a tax based on net income as that term is used in the U.S. This can be shown algebraically and by numerical example. By taking net income to the extent it exceeds a threshold level of normal profitability, the U.K. Windfall Tax is similar in structure to excess profits taxes imposed by the U.S. and the U.K. as far back as the First World War.

12. The concepts of income in the U.S. and the U.K. are fundamentally the same. Accounting is often referred to as the language of business. The core concepts of this language are largely the same in the U.S. and the U.K. The accounting

differences that exist between the two countries can be thought of as regional dialects, with differences in terminology and particular accounting standards existing, similar to differences in word usage and spelling in the English language across the Atlantic. When an accountant in the U.S. refers to "net income" and an accountant in the U.K. refers to "profit," they are talking about the same fundamental concept, much like "elevator" and "lift" refer to the same thing.

13. The concepts of income for U.S. tax and U.S. accounting purposes are related to each other. This is evident from the preparation of tax returns and tax provisions, when firms start with accounting income in their calculation of taxable income, and from the required reconciliation of the two in Schedules M-1 and M-3. Moreover, there was a period of time in which the U.S. explicitly based a portion of its income tax on accounting income (i.e., the book income adjustment of the AMT from 1987-1990), as the U.K. did with the Windfall Tax.

IV. Summary of the U.K. Windfall Tax

14. My understanding is that, following the privatization of certain companies, the U.K. levied a tax called the U.K. Windfall Tax in 1997. The U.K. Windfall tax was equal to 22 percent of the excess of:

    a. Nine times the average of the company's profits during the four years immediately following privatization (the "initial period"), over

b. The company's "floatation value," defined as the price paid for the stock by the public at the time of the privatization.

15. The profits upon which the tax is based are the accounting profits as reported in the company's public financial statements, prepared in accordance with U.K. accounting standards.

V. Definitions

16. Accounting income: The net of revenues and gains less expenses and losses, as determined under the Generally Accepted Accounting Principles (GAAP) applicable to the particular setting. For the purposes of this report I use the terms income, net income, profit, and earnings interchangeably. The Financial Accounting Standards Board (FASB) notes that "Present practice accepts a variety of terms for net income, and the Board anticipates that net income, profit, net loss, and other equivalent terms will continue to be used in financial statements as names for earnings."[1] Standard setting bodies sometimes discuss and distinguish additional measures of income that include or exclude certain items, but these distinctions are not important for the analysis in this report. For example, the FASB uses the term "comprehensive income" to refer to an expanded definition of income, stating that

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[1] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No.5: Recognition and Measurement in Financial Statements of Business Enterprises, 1984, paragraph 33.

"Earnings and comprehensive income have the same broad components-revenues, expenses, gains, and losses-but are not the same because certain classes of gains and losses are included in comprehensive income but are excluded from earnings."[2] Similarly, different measures of income can be found in the Internal Revenue Code (e.g., taxable income, adjusted gross income, earnings and profits).

17. Generally Accepted Accounting Principles: "Those accounting principles that have become established in a particular jurisdiction by formal recognition by a standard setting body or by authoritative support or precedent."[3]

18. Realization concept: "The accounting concept that revenue should generally be recognized when there has been an exchange transaction involving the transfer of goods and services."[4]

VI. The U.K. Windfall Tax is in Substance a Tax on Income.

19. Numerical example. Consider a firm subject to the U.K. Windfall Tax that has accounting profits of £100 per year during the four-year initial period following privatization. Suppose the firm had a floatation value of £500, representing the amount the public paid for the

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[2] Ibid., at paragraph 42.

[3] Coopers & Lybrand, International Accounting Summaries: A Guide for Interpretation and Comparison, 2nd edition, 1993, at GLO-4.

[4] Ibid., at GLO-S.

firm's stock at the privatization. The U.K. Windfall Tax would be calculated as follows:

Example 1: Base Case with £100 of Accounting Profit Per Year	
Average accounting profit during the initial period	£100 x 9
	£900
Less: floatation value	-£500
	£400
	x 23%
U.K. Windfall Tax	£92

20. Now consider the incremental taxes that would be due if the firm had an additional £100 of accounting profits in one of the years, say year 4.[5] This would increase the firm's average accounting profits in the four-year initial period by £25 from £100 to £125, as shown below:

(£100 + £100 +£100 + £200) / 4 = £125

The U.K. Windfall Tax with the additional profit would be:

[5] For ease of exposition, the analysis in this report assumes that the initial period consists of four years of 365 days each.

Example 2: Base Case Plus an Additional £100 of Accounting Profit One Year	
Average accounting profit during the initial period	£125 x 9
	£1,125
Less: floatation value	-£500
	£625
	x 23%
U.K. Windfall Tax	£143.75

21. What is the net result? By virtue of having an additional £100 of accounting profits in a single year, the firm's U.K. Windfall Tax increased by £51.75, for a marginal tax rate of 51.75%, as shown below:

Calculation of Marginal Tax Rate	
Tax with one year of additional £100 of accounting profits	£143.75
Less: Tax under Base Case	-£92
= Tax on additional £100 of accounting profits	£51.75
÷ Additional accounting income	÷£100
= Marginal Tax Rate	51.75%

22. As seen above, the U.K. Windfall Tax is in substance a tax on the accounting profits of the firm. An increase in the firm's accounting profits results in a direct increase in the firm's U.K. Windfall Tax at a marginal tax rate of 51.75%.

23. This can also be demonstrated algebraically. The U.K. Windfall Tax can be expressed as:

$$Tax = \left\{ \left[\frac{P_1 + P_2 + P_3 + P_4}{4} \times 9 \right] - FV \right\} \times 23\%$$

where FV is the floatation value of the firm and P_1, P_2 ... are the accounting profits of the firm in year 1, 2, etc. Expressing the tax based on the accounting profits from a single year (say P_1) gives:

$$Tax_1 = \left\{ \left[\frac{P_1}{4} \times 9 \right] - \frac{1}{4} FV \right\} \times 23\%$$

where $Tax = Tax_1 + Tax_2 + Tax_3 + Tax_4$. Now rearrange the terms a bit by multiplying everything inside the { } by 4/9 and multiplying the 23% by 9/4:

$$Tax_1 = \left(P_1 - \frac{1}{9} FV \right) \times 23\% \times \frac{4}{9}$$

This equals:[6]

$$Tax_1 + (P_1 - 11.1\% FV) \times 51.75\%$$

Thus, the U.K. Windfall Profit tax is, in substance, a tax on the annual accounting profits of the initial period to the extent they exceed an average annual return of approximately 11.1 % of the floatation value of the firm.[7]

24. The U.K. Windfall Tax is similar in substance to other excess profits taxes. Excess profits taxes

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[6] I round 1/9 to 11.1% for ease of exposition

[7] I understand that 31 of 32 companies subject to the U.K. Windfall Tax had a Windfall Tax liability.

have been imposed by a number of countries over time, including the U.S. and the U.K., particularly during times of war. The common characteristic of these taxes is to tax profit to the extent it exceeds a threshold normal" level of profitability. The thresholds are typically based on a specified return on the firm's invested capital or the firm's average profits over some prior period.[8] For example, in 1917, the U.S. enacted an excess profits tax at a rate of8 percent to the extent income exceeded 8 percent of invested capita1.[9] The tax was modified later that same year, providing for higher tax rates (up to 60 percent) on income in excess of various rates of return on invested capital.[10] It was modified again in the Revenue Act of 1918 and repealed by the Revenue Act of 1921.[11] The excess profits tax was revived again in the National Industrial Recovery Act of 1933, providing for a rate of 5 percent on income in excess of 12.5 percent of the declared value of capital stock.[12]

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[8] The descriptions of the excess profits taxes are simplified for expositional purposes.

[9] Lent, G., "Excess-Profits Taxation in the United States," Journal of Political Economy Vol. 59, No.6, 1951, pp. 481-497.

[10] Blakey, R., "The War Revenue Act of 1917," American Economic Review, Vol. 7 Issue 4, 1917, pp. 791-815.

[11] Blakey, R. and G. Blakey, "The Revenue Act of 1918," American Economic Review, Vol. 9, Issue 2,1919, p. 213-243; and Blakey, R., "The Revenue Act of 1921," American Economic Review, Vol. 12, Issue 1, 1922, pp. 75-108.

[12] Lent, G., op. cit., at 9. 483.

25. Excess profits taxes were also levied by the U.S. during the Second World War. The Second Revenue Act of 1940 provided for a tax of up to 50 percent on "excess profits net income" relative to 95 percent of average profits during the period 1936-1939 or 8 percent of invested capital.[13] The excess profits tax was modified several times and then repealed in 1945. During the Korean War an excess profits tax was enacted again with the Excess Profits Tax of 1950 and continued to 1953. By taxing profit to the extent it exceeds a threshold level of normal profitability, the U.K. Windfall Tax displays the common characteristic of an excess profits tax, including excess profits taxes levied by the U.S. at various points in her history.

26. The U.K. preceded the U.S. in imposing an excess profits tax, just as she preceded the U.S. in entering the World Wars. A 1918 publication for the Committee on Ways and Means, prepared by the Legislative Reference Division of the Library of Congress, summarized the excess profits taxes of the U.K. and a number of other countries.[14] The U.K. imposed an excess

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[13] Blakey, R. and G. Blakey, "The Two Federal Revenue Acts of 1940," American Economic Review, Vol. 30, Issue 4, 1940, pp. 725-735; and Editors of Columbia Law Review, the Yale Law Journal, and the Harvard Law Review, "Mobilization for Defense," Harvard Law Review, Vol. 54, No.2, 1940, pp. 278-329.

[14] Legislative Reference Division, Library of Congress, Taxation of Incomes, Excess Profits, and Luxuries in Certain Foreign Countries, Government Printing Office, 1918.

profits tax in the Finance (No.2) Act, 1915. The tax was imposed at a rate of 50 percent on excess profits (increased to as high as 80 percent in the Finance Act, 1917). Excess profits were measured relative to either prewar profits (the "profits standard") or a specified return on capital (the "percentage standard").

27. Excess profits taxes also were used by other countries, including the U.K., during the Second World War. With the passage of Finance (No.2) Act, 1939, the U.K. imposed an excess profits tax at a rate of 60 percent on all business profits in excess of "standard profits." The measure of standard profits was based on past profits or a specified return on capital, depending on the age of the business (e.g., for corporations commencing after July 1, 1936, standard profits were set at 8 percent of average capital). The Finance Act, 1940, increased the excess profits tax rate to 100 percent, though it was later determined that a portion would be refunded.[15] The Finance (No.2) Act, 1945, reduced the excess profits tax rate to 60 percent and provided for a 20-percent refund of all excess profits taxes that had been paid at the 100-percent rate. The Finance Act, 1946, repealed the U.K. excess profits tax as of January 1, 1947.[16] As with the U.K. excess profits taxes of

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[15] Farnsworth, A., "The Finance Act, 1940," The Modem Law Review, Vol. 4, No.2 (Oct, 1940), pp. 136-137.

[16] Farnsworth, A., "The Finance Act (No.2), 1945, and the Finance Act, 1946," The Modem Law Review, Vol. 9, No.3 (Oct, 1946), pp. 289-293.

First and Second World Wars, the U.K. Windfall Tax is based on profits that exceed a threshold level of normal profits.

VII. The Concepts of Income in the U.S. and U.K. Are Fundamentally the Same.

28. It is probably not surprising that the concepts of income in the U.S. and U.K. are fundamentally the same given the common language and deep historical and economic ties between the two countries. U.S. accounting in large part originated from the U.K. As Benston, et al. (2006) state, "The United States imported independent professional accounting and auditing from the United Kingdom. Indeed, the important U.S. accounting firms began as branches of U.K. firms."[17] Moreover, each of the current "Big Four" accounting firms has roots running back to the U.K.

a. Deloitte, Touche, Tohmatsu can trace its roots back to William Deloitte, who opened an accounting office in London in 1845, and George Touche, who did so in 1898, also in London.[18]

b. Ernst & Young can trace its roots back to a firm named Harding & Pullein, which was founded in England in 1849. The names Ernst &

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[17] Benston, G., M. Bromwich, R. Litan, and A. Wagenhofer. Worldwide Financial Reporting: The Development and Future of Accounting Standards. Oxford University Press, 2006, at p. 51.

[18] Deloitte, Touche, Tohmatsu, "The Journal to Today: Select Moments in the History of Deloitte" at www.deloitte.com.

Young come from the U.S. side, in particular Alwin and Theodore Ernst, who founded Ernst & Ernst in Cleveland in 1903, and from Arthur Young, who founded a firm by his name in Chicago in 1906. The U.K. and U.S. firms later combined.[19]

c. KPMG can trace its roots back to William Peat (the "P" in KPMG), who cofounded a firm in London in 1870 that later merged with the New York-based firm Marwick, Mitchell & Co. in 1925.[20]

d. PricewaterhouseCoopers can trace its roots back to Samuel Price, who opened an accounting office in London in 1849, and William Cooper, who did so in 1854.[21]

29. Later, the flow of thought ran the other way. As Nobes, et al. (2006) put it, "In the nineteenth century, Britain took the lead in accounting matters, followed in the twentieth century by the United States."[22] Indeed, the U.K. Accounting Standards Board (ASB) describes its Statement of Principles as being ultimately

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[19] Ernst & Young, "Key dates for Ernst & Young" at www.ey.comlglobal.

[20] KPMG, "History" at www.kpmg.co/ukl.

[21] PricewaterhouseCoopers, "History and milestones" at www.pwc.com.

[22] Nobes, et al., Comparative International Accounting, 9th ed., 2006, p. 16.

based on the U.S. FASB's Statements of Financial Accounting Concepts, writing:[23]

> ... the Statement of Principles is based on the International Accounting Standards Committee's 'Framework for the Preparation and Presentation of Financial Statements' (the IASC Framework), which was itself derived from the Statements of Financial Accounting Concepts issued in the USA by the Financial Accounting Standards Board.

30. The Statement of Principles of the U.K.'s ASB is akin to the Statements of Financial Accounting Concepts of the U.S.'s FASB. Both describe the underlying concepts that the standard setters believe set the bedrock of financial reporting, and both the ASB and FASB look to their respective concepts statements when setting specific accounting standards.

    a. The ASB describes the purpose of its Statement of Principles as containing "... the principles that the Accounting Standards Board believes should underlie the preparation and presentation of general purpose financial statements."[24]

    b. The FASB has six active Statements of Concepts, and describes their purpose as "... to

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[23] Accounting Standards Board, Statement of Principles for Financial Reporting, 1999.

[24] Ibid., at paragraph 1.

set forth fundamentals on which financial accounting and reporting standards will be based. More specifically, Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standards Board will use in developing standards of financial accounting and reporting."[25]

c. Striving for harmony in accounting across countries, the ASB concluded that "... the principles and explanations in the statement are similar to those set out in the conceptual statements issued by other leading accounting standard-setters, including those in Australia, Canada, New Zealand and the USA."[26]

31. Both the U.S. and U.K. concepts of income reflect the net gain (or loss) that obtains from adding up gross revenues and subtracting expenses. Realization is important for both concepts of income, as both generally record (or "recognize" in the parlance of accounting) revenues when they have been realized and earned. Both concepts of income start with gross revenues and then subtract expenses attributable to those revenues to arrive at net income.

32. The links between accounting in the U.K. and the U.S. even extend to similar names and

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[25] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No.1: Objectives of Financial Reporting by Business Enterprises, 1978, page 6.

[26] Accounting Standards Board, op. cit., at Appendix II.

structures for their standard setting bodies. Accounting standard setting in the U.S. is primarily set by the Financial Accounting Standards Board (FASB), which was established in 1973. Instead of the *FASB*, the U.K. has the *ASB*, or Accounting Standards Board, which was established in 1990 to replace the Accounting Standards Council (ASC). Both the FASB and the ASB are private rulemaking bodies that are authorized by their respective governments to set accounting standards. The FASB promulgates Statements of Financial Accounting Standards (SFAS's), while the ASB promulgates Financial Reporting Standards (FRS's). To provide timely response to emerging accounting issues, the FASB has an Emerging Issues Task Force, or EITF. Instead of *EITF*, the U.K. has an *UITF*, or Urgent Issues Task Force.

33. Empirical research also shows similarities of U.S. and U.K. accounting. For example, Guenther and Young (2000) conduct an empirical examination of accounting earnings in various countries and find that accounting earnings in the U.S. and U.K. are more closely associated with underlying economic activity than are accounting earnings in France and Germany during the period 1983-1997.[27]

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[27] Guenther, D. and D. Young, "The association between financial accounting measures and real economic activity: a multinational study." Journal of Accounting and Economics. 2000:5372.

34. Despite the conceptual linkages, there are numerous differences in terminology between U.S. and U.K. accounting. As noted earlier, accounting is often referred to as the "language of business." U.S. travelers in the U.K. find that they speak the same language and can be understood, though sometimes people in the U.S. and U.K. use different words to refer to the same thing, e.g., "lift" versus "elevator," and "flat" vs. "apartment." Similarly, accountants in the U.S. can examine a set of financial statements from the U.K. and, after adjusting for some differences in terminology and format, can feel right at home. Language differences do exist, such as "profit" instead of "net income," and "turnover" instead of "sales," but these differences are relatively minor in the grand scheme of things. Some differences between the U.S. and U.K. in accounting terminology for the same fundamental items include:[28]

U.S.	U.K.
Accounts Payable	Creditors
Accounts receivable	Debtors
Income	Profit
Inventories	Stocks
Leverage	Gearing
Sales	Turnover
Stock Split	Bonus Issue

[28] Nobes, et al., op. cit., at table 7.6.

35. At a more detailed level, differences in specific accounting standards do exist between the U.S. and the U.K. Accounting standard setters around the world grapple with some of the same tough issues that tax authorities grapple with, such as how to treat goodwill. Should it be amortized? Capitalized indefinitely? If it is to be amortized, over what period? In conceptually difficult areas it is not surprising that one observes variation in rules both among standard setting bodies at a point in time and within standard setting bodies across time.

a. In the case of goodwill, the rule in the U.S. used to be that goodwill had to be amortized into income over a period of 40 years or less.[29] The FASB changed the rule in 2001, however, so that now goodwill is no longer amortized under U.S. GAAP. Instead, goodwill remains on firms' balance sheets with no charge to accounting income unless the firm determines that the goodwill is impaired, in which case the impairment charge is typically recorded against income.[30]

b. In the U.K., rules effective in 1998 require goodwill to be amortized over its useful life. However, the rules allow the possibility of

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[29] Accounting Principles Board, Opinion No. 17: Intangible Assets, 1970. The Accounting Principles Board (APB) was the predecessor accounting standard setter to the F ASB.

[30] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 142: Goodwill and Other Intangible Assets, 2001.

indefinite lives, resulting in no amortization and instead an annual impairment test.[31] Prior to 1998, goodwill in the U.K. was amortized over its useful life or could be written off immediately against reserves.[32]

c. Treatment of goodwill and other intangibles has changed over time for U.S. tax purposes as well, most notably with the passage of IRC §197 in 1993.

d. These examples illustrate that even with a consistent underlying concept of income, the exact measurement of the income can differ. Indeed, the study of differences in accounting over time is an area of interest for accounting researchers.

36. In addition, U.K. GAAP is less voluminous than U.S. GAAP and is said to be more principles-based (rather than rules-based) than U.S. GAAP. U.K. accounting has an underlying principle called the "true and fair view," in which a firm's financial statements are required to present a true and fair view of the firm's financial performance and financial position.

37. While differences in accounting standards exist between U.S. and U.K., it should be noted that differences also exist within the U.S. at different times as GAAP changes. Consequently, if one were to apply U.S. GAAP from two different

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[31] Accounting Standards Board, Financial Reporting Standards No. 10: Goodwill and Intangible Assets, 1997.

[32] Nobes, et al., op. cit., at page 82.

time periods to the same set of transactions, one would often get somewhat different answers. The same holds true for tax laws that change over time; applying the IRC from two different points in time to the same set of transactions would often give a different set of results. Thus, differences in the specific measurement of income can exist even when the underlying concept of income is the same. Many of the differences between the measurement of income in the U.S. and the U.K. are matters of timing, i.e., in what period to recognize revenue and expense.[33] Timing differences are mitigated to the extent one considers a multi-year horizon, e.g., aggregating or averaging income over a four-year period, as the U.K. Windfall tax does.

38. Currently, there is a movement toward further convergence of accounting standards by adoption of International Financial Reporting Standards (IFRS), which are issued by the International Accounting Standards Board (IASB). At present, over 100 countries, including the U.K., have adopted IFRS. The Securities and Exchange Commission (SEC) recently proposed a "roadmap" in which IFRS would be phased-in for U.S. issuers, beginning with optional adoption by certain entities in 2010 and mandatory adoption in 2014.[34] The FASB and

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[33] Ball, R., S. Kothari and A. Robin, "The effect of international institutional factors on properties of accounting earnings." Journal of Accounting and Economics, 2000: 1-51.

[34] Securities and Exchange Commission, "SEC Proposes Roadmap Toward Global Accounting Standards to Help

the IASB have been working together to remove differences between their respective accounting standards since 2002.[35]

39. It should be noted that there exist different measures of income in financial accounting (e.g., comprehensive income, earnings) even within a set of GAAP, just as there are different measures of income for Federal tax purposes (e.g., taxable income, adjusted gross income, alternative minimum taxable income). Although the particular measures may differ in their specifics, they can still be measures of income nonetheless. They generally represent a measure of the net gain for the firm during a period, and reflect the difference between revenues and expenses. The differences across the income measures are often matters of exactly which revenues and expenses to include for the purpose at hand and/or how much of a particular revenue or expense to record in one period versus another period (matters of timing).

Investors Compare Financial Information More Easily," Press Release 2008-184, August 27, 2008.

[35] Financial Accounting Standards Board and International Accounting Standards Board, "Memorandum of Understanding," September 18, 2002.

VIII. The Concepts of Income for U.S. Tax and U.S. Accounting Purposes Are Related to Each Other.

40. This is evident from the preparation of U.S. Federal tax returns, when firms start with accounting income in their calculation of taxable income, and from the required reconciliation of the two in Schedules M-1 and M-3.[36]

41. Relations between tax and accounting income are also evident when preparing the tax provision, which involves how income taxes are reflected in firms' financial statements. Tax provisions involve reconciling the differences between tax and accounting income and understanding the nature of those differences (e.g., whether the differences are permanent or temporary).[37]

42. Moreover, there was a period of time in which the U.S. explicitly based a portion of its income tax on accounting income (Le., the book income adjustment of the AMT from 1987-1990), as the U.K. did with the Windfall Tax. An excerpt from former IRC §56(f) follows:[38]

    (f) Adjustments for book income of corporations.

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[36] Geuther, D., S. Nutter, and E. Maydew, "Financial Reporting, Tax Costs, and Book-Tax Conformity," Journal of Accounting and Economics 23, 1997: 225-248.

[37] Scholes, M., M. Wolfson, M. Erickson, E. Maydew, and T. Shevlin, Taxes and Business Strategy: A Planning Approach, 4th edition, 2009 (Pearson/Prentice Hall).

[38] Former IRC §56(f).

(1) In general. The alternative minimum taxable income of any corporation for any taxable year beginning in 1987, 1988, or 1989 shall be increased by 50 percent of the amount (if any) by which—

(A) the adjusted net book income of the corporation, exceeds

(B) the alternative minimum taxable income for the taxable year (determined without regard to this subsection and the alternative tax net operating loss deduction).

IX. Conclusions

43. The U.K. Windfall Tax is in substance a tax based on net income as that term is used in the U.S. The tax is levied on realized income to the extent it exceeds a threshold level, similar to excess profits taxes levied in the past by many countries, including the U.S. and the U.K. The concept of income or profit in U.K. is fundamentally the same as in the U.S. The concepts of income for U.S. tax and U.S. accounting purposes are related to each other.

[Appendices omitted in printing this appendix]

EXHIBIT 143-P

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Report of Stewart C. Myers On Behalf of
PPL Corporation and Subsidiaries

September 8, 2008

[Table of Contents omitted in printing this appendix]

I. INTRODUCTION & SUMMARY OF CONCLUSIONS

I have been asked to evaluate the economic substance and predominant character of the U.K. Windfall Tax enacted in 1997. This tax was imposed on 32 companies in the telecommunications, natural gas, electric, water and sewage, and rail industries. The

companies included South Western Electricity Board (SWEB), which was later acquired by PPL Corporation. The tax was motivated by a public or political perception of excessive profits after these companies were privatized in the late 1980s and early 1990s.

The mechanics of the Windfall Tax are clear, but its substance and character are disputed. I understand that the Internal Revenue Service (IRS) argues that it is a tax on the undervaluation of the 32 companies when they were privatized and their shares were sold to investors in initial public offerings (IPOs). The U.K. legislation creating the tax refers to "value of disposal in profit-making terms." The Windfall Tax formula also appears to value the companies by multiplying average earnings by a price-earnings (P/E) multiple. On the other hand, the Windfall Tax liabilities were determined by the companies' realized earnings over the first four post-IPO years. This indicates that the Windfall Tax was a tax on profits or on excess profits.

The amounts of Windfall Tax varied across the 32 privatized firms. I analyzed this variation to see whether it is explained by differences in profits (net income) or differences in value. I show that the Windfall Tax operated as an excess profits tax, not as a tax on value, change in value or undervaluation. I also examined the Windfall Tax formula to see if it can be simplified or reorganized to reveal what determined the tax. Both analyses show that the Windfall Tax was really an excess profits tax.

My conclusions are as follows:

- "*Value ... in profit-making terms*" *is not a standard economic term or concept.* It has no meaning in other contexts. It does not appear in the financial, accounting or management literature. It is an ad hoc, one-off term that cannot reveal the economic substance or predominant character of the tax.

- *The Windfall Tax formula is equivalent to the formula for an excess profits tax.* The Windfall Tax formula is equivalent to:

  Windfall Tax = (Net Income − base return on Equity Capital) × Effective tax rate

  The effective rate is 51.75%. The base rate of return is 11.1%, which is a reasonable estimate of the cost of equity capital. "Equity capital" equals value at IPO.

  Windfall Tax = (Net Income − 11.1% × Equity Capital) × 51.75%

  Excess profits (net income in excess of an 11.1% return on equity) were taxed at 51.75%.

- *The privatized companies' IPOs were normal. There was discounting but no unusual undervaluation.* Selling prices of IPOs are almost always discounted from the expected or hoped for trading price. Trading prices typically increase immediately after the offering. The initial trading prices for the 32 privatizations followed this typical pattern, increasing about 18% on average. This run-up

was not related to later increases in profits or to the amounts of Windfall Tax that were eventually paid. The privatized companies' stock prices did increase, but only gradually as profits were generated. These profits were higher than expected. Otherwise, investors would have bid up prices much more aggressively shortly after the IPOs.

- *The Windfall Tax formula does not measure economic value.* The formula multiplies average earnings by 9. This multiple does not match actual price-earnings ratios at or after the IPO dates and cannot measure value accurately. First, the ratio of 9 was neither an average nor a floor (lower bound) for initial P/E ratios. Second, the ratio was used retroactively. It was applied to four years of past earnings, which could not have been anticipated at the times of privatization. Third, any "excess" in past earnings must have been transitory, given the design of U.K. regulation. Valuation in practice is based on current earnings and expectations of future earnings, not on transitory past earnings. "Value in profit-making terms" was not a value that the IPOs would, could or should have had. It was a one-off device created to determine tax liability.

- *The Windfall Tax depended on net income, not value.* The amounts of Windfall Tax varied across the 32 privatized companies. Most of the variation can be explained by differences in net income. The variation cannot be

explained by differences in IPO value or by changes in value post IPO.

- *The Windfall Tax operated as a tax on excess profits.* I show this by calculating excess profits over base returns on equity capital for the 22 privatized water and regional electric companies. I defined equity capital as the equity-financed part of the regulatory asset base used by U.K. regulators. I used real base rates of return that approximate the U.K. regulators' estimates of the real (inflation-adjusted) cost of equity capital. The Windfall Taxes paid by these companies track my calculation of excess profits almost exactly. This is strong evidence that the Windfall Tax was really a tax on excess profits.
- *Actual values were not used in the Windfall Tax formula.* The privatized companies were valued daily on the London Stock Exchange. The designers of the Windfall Tax could have used stock-market values to identify (with hindsight) the "undervaluation" of the companies on or after their IPO dates. Instead they settled on a formula in which the chief moving part was not value but profits.

II. QUALIFICATIONS

I am the Robert C. Merton (1970) Professor of Finance at MIT's Sloan School of Management, a Research Associate of the National Bureau of Economic Research, and a Principal of *The Brattle Group, Inc.* I am past President of the American Finance Association and co-author, with Richard

Brealey and Franklin Allen, of *Principles of Corporate Finance*, now in its 9th edition.

Most of my research and teaching focuses on corporate investment and financing decisions, including the measurement of profitability and the valuation of real and financial assets. I have studied corporate capital structure and financing decisions. I have consulted in the insurance, energy, mining, software, banking, pharmaceutical and other industries. I have served as expert witness in major cases and regulatory proceedings.

I have prepared this report based on my practical and academic experience in economics and finance. I stand by all of the report's analysis and conclusions. I do not offer any legal analysis of the tax issues in this case. The sources and documents on which I based my opinions are cited in footnotes to the text and Figures. I have been assisted by staff of *The Brattle Group, Inc.*, who worked under my direction and supervision. A more detailed statement of my qualifications is attached as Appendix A. The statement contains a list of publications, including all publications in the last ten years, and a list of expert reports and testimony, including all cases in which I have testified at trial or deposition in the last four years. I have been compensated for my work on this case at my standard consulting rate, currently $1000 per hour. I will be compensated at my standard hourly rate for any further work, including any testimony at deposition or trial.

III. BACKGROUND

A. U.K. Privatization and RPI-X Price Regulation

Margaret Thatcher took office on May 4, 1979. One of her initiatives was a program to privatize public enterprises. Between 1979 and 1997, there were 48 major privatizations implemented by IPOs or private equity sales. British Telecommunications was the first privatization in 1984, followed by British Gas in 1986 and the British Airports Authority in 1987. All water and sewer utilities were privatized on December 11, 1989 under the Water Act (1989). All regional electric utilities, including South Western Electricity Board, were privatized on December 11, 1990 under the Electricity Act (1989).

A regulatory environment for the newly privatized utilities was established. The Secretary of State adopted a price-cap approach to setting tariffs for the Water and Sewage Companies (WASCs) and for the Regional Electricity Companies (RECs). This price-cap mechanism was developed by Dr. Stephen Littlechild, who became the chief regulator of the U.K. electric sector.

Price-cap regulation allows base-year prices to escalate at a rate determined by the formula RPI-X. RPI is inflation measured by the Retail Price Index, and X is a company-specific efficiency factor that is fixed for each regulatory period (usually five years). RPI and X are expressed as percentages. The regulated firm can increase average prices by at most RPI-X percent per year. Since RPI is a measure of inflation, a positive X results in declining real prices.

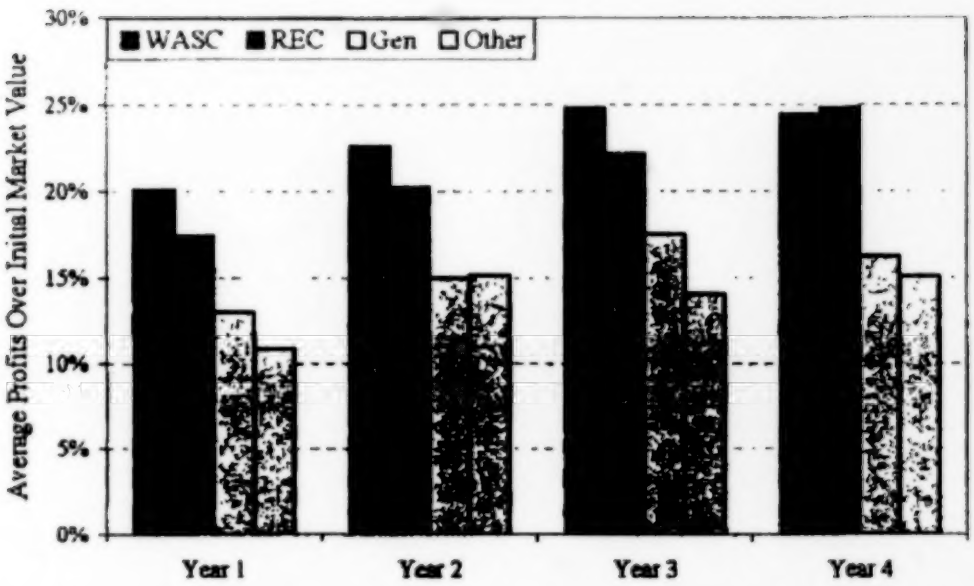
The RPI-X method regulates prices, not profits. The method is designed to provide incentives for companies to reduce costs, and improve operating efficiency. For example, suppose that RPI=5% and a company's X=2%. The company is then allowed to increase the average prices for its product or service by 5-2=3% that year. If the company can find ways to hold its growth in costs to less than 3%, or better still reduce them, then its revenues will grow faster than its costs, and profits will increase.

Cost reductions flow to the bottom line of net income, but the regulator steps in and adjusts prices at the start of the next regulatory period. At this point, cost savings are passed on to consumers. The regulator sets a new X for each regulatory period and can also reset starting prices for the new period. The new X and the starting prices are calibrated so that the regulated company can expect to earn its cost of capital on its regulatory asset base.[1] The regulatory asset base measures the value of the assets employed to produce the regulated products or services.

Thus a company that cuts costs and improves efficiency can generate extra profits, but only during the regulatory period. The extra profits are transitory. The RPI-X method gives the regulated company a temporary reward for improved efficiency, then passes the efficiency gains on to customers through lower rates in subsequent periods.

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[1] "Regulatory asset base" plays much the same role as "rate base" does for U.S. utilities.



Sources and Notes: Profits from companies' annual statements of accounts; Market Values from Datastream. Initial Market Value is calculated as the average closing price over the first 20 trading days after IPO.

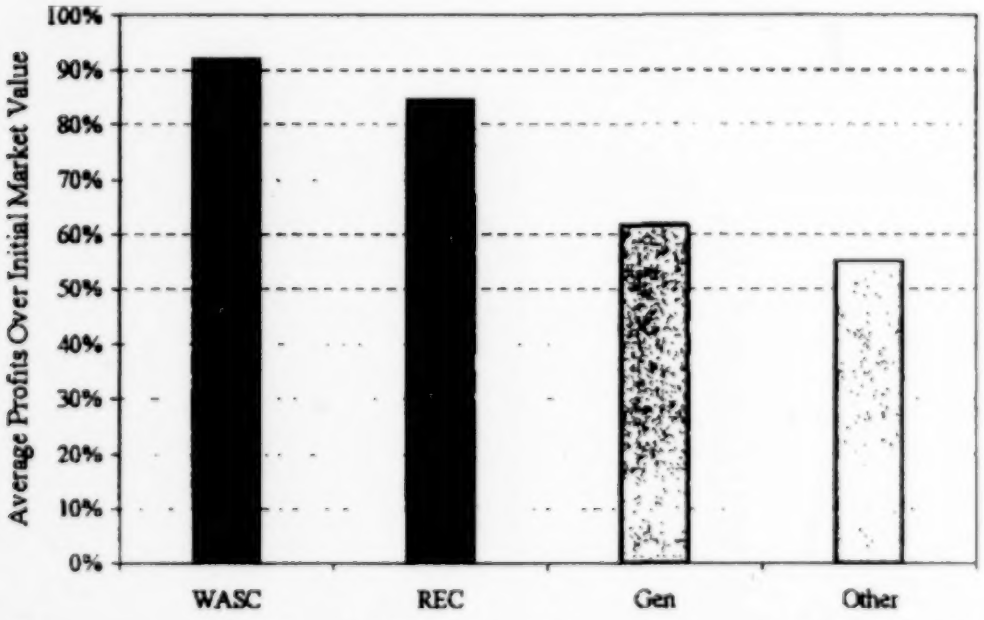
Figure 1. Average income by industry over the Windfall Tax periods. Each company's net income is calculated as a percentage of its initial market value.[2] The WASCs and RECs were highly profitable. Generators and other companies (British Telecom, British Gas, British Airport Authority, Railtrack and British Energy) had healthy but lower returns.

Most of the privatized companies were able to reduce costs dramatically during their initial regulatory periods. Therefore profits increased

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[2] Companies' annual statements of accounts obtained from the Companies House (www.companies-house.gov.uk).

dramatically. Figure 1 above shows average income by industry in each of the first four years post-privatization, expressed as a percentage of each company's initial market value. Figure 2 shows cumulative averages over these four years. The WASCs generated average returns of 20.1% in their first post-IPO years (Figure 1) and an average cumulative return of 92% over their first four years (Figure 2). The RECs delivered average first-year returns of 17.4% and cumulative returns of 84.8%. Figure 2 shows that these companies earned back almost all of shareholders' initial investments in just four years. The performance of the Generators and "Other" companies earned relatively lower returns. ("Other" includes British Telecom, British Gas, British Airport Authority, Railtrack and British Energy.)



Sources and Notes: Profits from companies' annual statements of accounts; Market Values from

Datastream. Initial Market Value is calculated as the average closing price over the first 20 trading days after IPO.

Figure 2. Average cumulative income by industry over the Windfall Tax periods. Again, the WASCs and RECs were highly profitable, nearly recovering initial investment at IPO in a short four years. Generators and Other companies (British Telecom, British Gas, British Airport Authority, Railtrack and British Energy) had healthy but lower returns.

Investors in the WASCs and RECs did very well. Figure 3 compares their cumulative returns from dividends and stock-price appreciation to cumulative returns on the London stock market as a whole (the FTSE index). The WASCs' cumulative return was 45% by the end of the first year and 237% by the end of the fourth year after privatization. This compares to an average FTSE return of -7% for the same first year, 1990, and 65% for the period of March 1991-1994. The RECs' average one—and four-year returns were 44% and 292%, compared to FTSE returns of 15% and 68% for the period of March 1992-1995. These returns are particularly impressive given the below average market risk for RECs and WASCs.[3] A public perception of excess profits is not surprising given this performance.

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[3] The WASCs and RECs had betas between 0.5 and 0.85 in the early 1990s, vs. a beta of 1.0 for the average stock in the FTSE index. Betas are a standard measure of risk to diversified investors.



Sources: Datastream.

Figure 3. Total industry returns for the RECs and WASCs relative to the overall London stock market (the FTSE All Share Index). Returns include both stock price appreciation and reinvested dividends. REC and WASC returns are equal-weighted.

B. THE WINDFALL TAX

The U.K. Windfall Tax was created by the Finance (No.2) Act of 1997. Part 1, §1 of the Act says:

> (1) Every company which, on 2nd July 1997, was benefiting from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation shall be charged with a tax (to be known as the "windfall tax") on the amount of that windfall.
>
> (2) Windfall tax shall be charged at the rate of 23 per cent.

Computation of the tax was set out in Schedule 1 §1-2 of the Act as the difference between:

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and

(b) the value which for privatization purposes was put on that disposal.

The "value in profit-making terms" was defined as "the average annual profit for the company's initial period" multiplied by "the applicable price-to-earnings ratio" of 9. Profits were defined as the net income (after interest and all other taxes) reported in the companies' financial statements.[4] "Value for privatization purposes" was the highest issue price per share at the IPO multiplied by the number of shares issued. The "initial period" covered the first four fiscal years after privatization.[5]

"Value in profit-making terms" is not a standard economic term or concept. It does not appear in financial, accounting or management literature or practice. I have never encountered it except in this case. It is an ad hoc, one-off phrase that does not appear in Google or MS Search, except as linked to the U.K. Windfall Tax. The phrase does contain

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[4] Net income is as reported in company annual financial statements for consolidated operations in accordance with the Companies Act of 1985 (Schedule 1, §6).

[5] Three firms had not completed four fiscal years before passage of the Act. Their initial period started at the IPO date and continued to the end of their last fiscal year ending before April 1, 1997. Computation of profits for these firms' initial periods is set out in Schedule 1, §6 (3) - (6).

"value" as well as "profit," but the fact that it was labeled value does not make it so. The only way to decide the economic substance or predominant character of the tax is to analyze how the tax actually worked in practice.

The Windfall Tax formula is:

(1)

$$\text{Windfall Tax} = \left(\frac{NI_1 + NI_2 + NI_3 + NI_4}{4} \times 9 - \text{IPO Value} \right) \times 23\%$$

$NI_1 + NI_2 + NI_3 + NI_4$ is the total net income (after corporate income taxes) in the four years after privatization. Total net income is divided by 4 to get "average annual profit"[6] and multiplied by 9 to get "Value in profit-making terms." IPO VALUE is the total market value of the privatized company's equity at the IPO price.[7]

The IRS appears to interpret the Windfall Tax formula as a 23% tax on the difference between two values, "value in profit-making terms" and IPO VALUE. "Value in profit-making terms", however, depends entirely on post-IPO net income and the number 9. I will consider whether multiplying average net income by 9 really measures value, or

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[6] The average was actually calculated by dividing 365 by a count of the total number of days in the initial period. For most companies, the result was almost exactly equal to ¼.

[7] The IPO value is computed using the highest fixed offer price (typically the institutional price) in the flotation. For companies with less than 85% of their shares floated, profits and flotation value were scaled in proportion to the number of shares that were publicly issued (Finance (No.2) Act 1997, Schedule 1, §6).

whether the multiplication was just a way to get an excess profits tax that did not look like an excess profits tax.

The Windfall Tax can be written as:[8]

(2)

$$\text{Windfall Tax} = \left(NI_1 + NI_2 + NI_3 + NI_4 - 4 \times \frac{1}{9} \times \text{IPO Value} \right) \times 51.75\%$$

The reciprocal of 9 is 1/9 = 11.1%, so:

(3)

$$\text{Windfall Tax} = (NI_1 + NI_2 + NI_3 + NI_4 - 4 \times 11.1\% \times \text{IPO VALUE}) \times 51.75\%$$

This is equivalent to four annual taxes on profits above 11.1% of IPO VALUE:

$$\text{Windfall Tax} = \left\{ \frac{(NI_1 - 11.1\% \times \text{IPO Value})}{\text{Excess profits in Year 1}} + \ldots + \frac{(NI_4 - 11.1\% \times \text{IPO Value})}{\text{Excess profits in Year 4}} \right\} \times 51.75\%$$

The Windfall Tax formula therefore gives exactly the same result as a tax on excess profits, where "excess" means profits exceeding a benchmark annual return of 11.1% on IPO VALUE. The tax rate is 51.75%. SWEB paid this effective tax rate when it restated its earnings and sought a Windfall Tax adjustment. I understand that it received an adjustment equal to 51.75% of the earnings restatement.

Why could it make sense to tax profits above a given return on IPO VALUE? A conventional excess

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[8] To get from Equation (1) to Equation (2), simply multiply all terms inside the brackets by 4/9 and the tax rate by 9/4. The Windfall Tax is unchanged, because (4/9) × (9/4) = 1.

profits tax would set a benchmark return on the equity capital reported in standard financial statements. But in this case the book values of nationalized companies before privatization were often not meaningful. For example, publicly funded water and sewage systems were recorded at replacement value in the companies' books. These were far above the companies' actual values at privatization. IPO VALUE revealed what investors thought privatized companies were actually worth.

The privatized companies were and are regulated. U.K. regulators adopted the practice of setting the companies' prices (by RPI−X) at levels designed to offer a reasonable return on their regulatory asset bases. These regulatory asset bases were developed from the companies' IPO VALUEs. Thus IPO VALUE was not just a temporary initial stock-market value. IPO VALUE was the starting point for determining the revenues and profits that the privatized companies were allowed to earn after the initial regulatory period.

IV. VALUATION OF THE PRIVATIZED COMPANIES

A. IPO VALUATION

The IPOs of the U.K. utilities were not remarkable except in their scope. As is common with IPOs, the utilities experienced first-day increases in value of several percentage points. Figure 4 compares the initial price run-ups for the U.K. utilities with average run-ups for IPOs in several countries.

As the table highlights, it was not unusual to observe a first-day gain of 10% to 35% in IPOs

between 1990 and 2003.[9,10] The IPO run-ups in the U.K. privatizations were not unusual, especially in light of two special concerns of the U.K. government:

1. A slightly low initial price also served the need for these privatization programs to be successful over repeated public offerings, i.e., the U.K. government had to consider impacts of one IPO pricing on future IPOs; and

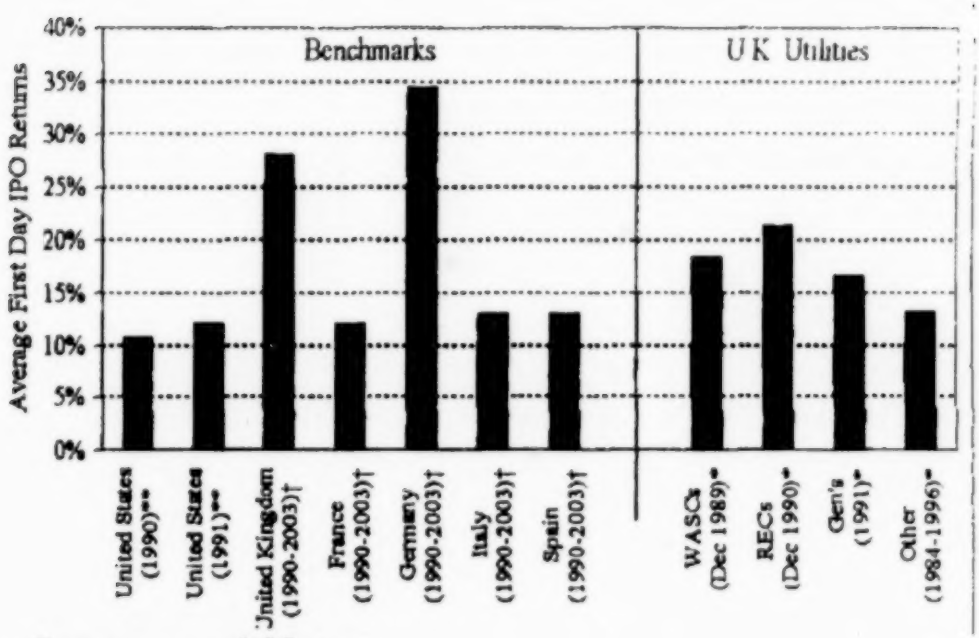
2. The U.K. also wanted to achieve wide public investment in the privatized companies and to assure that they were fully subscribed.

The fact that the utilities' IPOs were not unusual is also demonstrated by Figure 3 above, which shows gradual price appreciation over several years following the IPOs. Prices did not exhibit sudden, one-time jumps after the IPO dates, followed by "normal" market behavior. This implies that investors only gradually became aware of the cost-cutting performance of the privatized companies. This performance was not expected.

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[9] The upper end of the range may be partially driven by the inclusion of the "tech bubble" years of 1999-2001.

[10] Initial IPO gains have been attributed to a number of factors in the literature, such as compensating underwriting risk, facilitating subsequent offers, and protecting buyers from the "winners curse." See Chapter 16 in R. A. Brealey, S. C. Myers and F. Allen, *Principles of Corporate Finance*, 9th ed., McGraw-Hill Irwin, 2008.



Sources and Notes:

* Datastream.

** Ritter, Jay R., and Ivo Welch (2002) "A review of IPO activity, pricing, and allocations," *Journal of Finance* 57, 1795-1828.

†Ljungqvist, Alexander (2004) "IPO underpricing", in B. E. Eckbo, ed.: *Handbook of Corporate Finance: Empirical Corporate Finance*, vol. 1 . Chapter 7 (Elsevier/North-Holland, Handbooks in Finance Series).

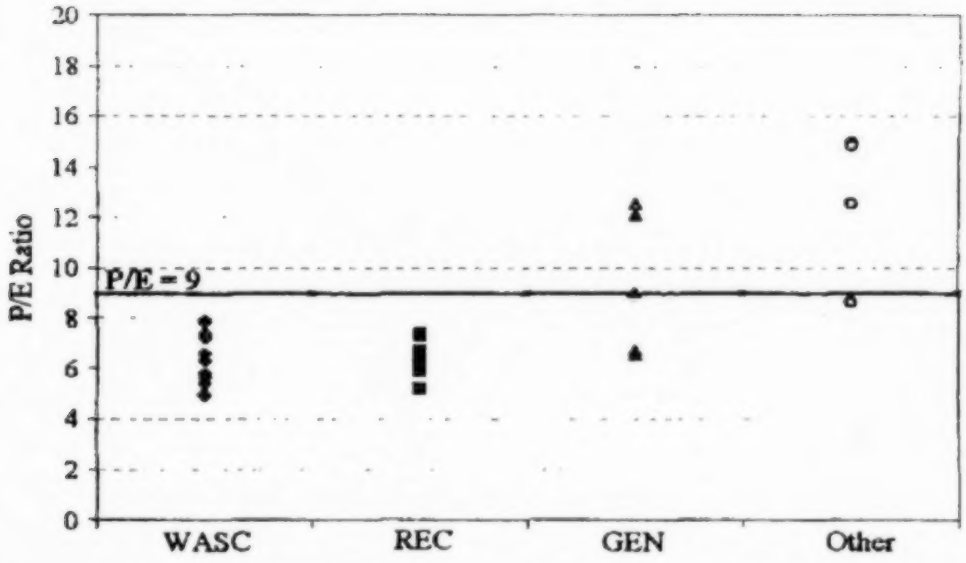
Figure 4. Comparing first-day IPO premiums in the U.S. and Europe to those of the privatized U.K. companies.

B. VALUATION AND P/E RATIOS

A P/E multiple of 9 is used in computing "value in profit-making terms." Is this a valuation parameter, or just a number used to scale up earnings for a desired amount of tax? The economic

definition of value for a firm, project, or line of business is the risk-adjusted present value of its expected future cash flows. In an efficient financial market, stock prices reflect economic value. Thus value is forward-looking. It is based on information about future performance. Assigning value based on a hindsight view of past performance is naïve and in many cases worthless.

P/E ratios are sometimes used to compare investments or as a shortcut for calculating value. For example, P/E ratios could be used when an analyst cannot observe market value. The value of a non-traded firm that has reported income but no stock price might be roughly estimated using the P/E multiples of similar proxy firms that do have publicly traded stocks. However, finding good proxy for companies is rarely easy. The proxy firms should be in the same industry, face similar risks, and have similar capital structures and growth opportunities. The privatized firms that paid the Windfall Tax were not all similar. We know this from their actual P/E ratios, which are shown in Figure 5.



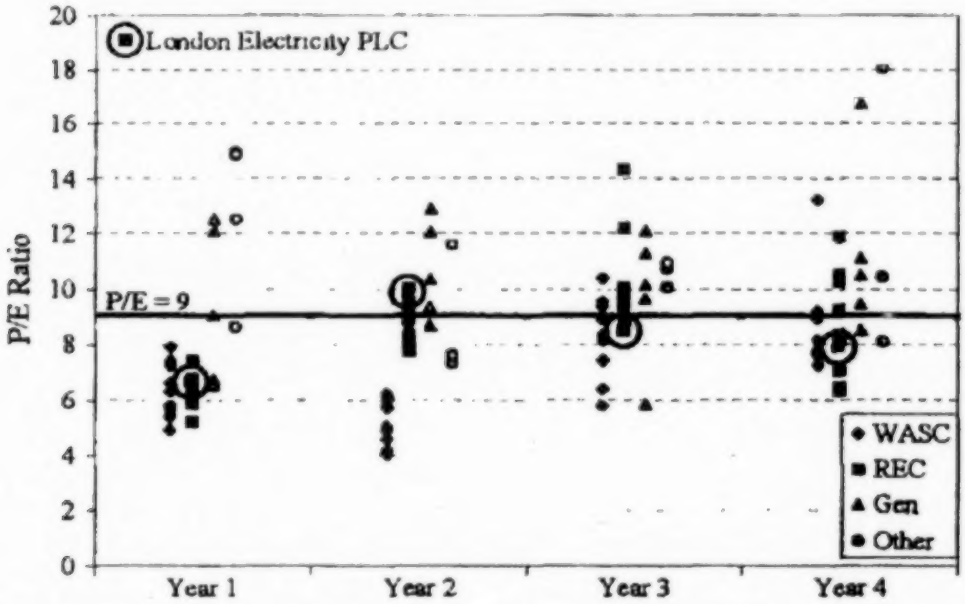
Sources: Datastream and companies' annual statements of accounts.

Figure 5. First-year trailing price-to-earnings ratios by industry. These are computed as two-week average prices at the end of the first fiscal year post-IPO divided by net income for that fiscal year. For the WASCs and RECs, all P/Es are less than 9.

This figure depicts P/E ratios by industry for each privatized firm based on first-year earnings and actual stock prices. It demonstrates that a P/E of 9 is not a reliable multiple for valuing these companies. P/Es averaged about 6 for the WASCs and RECs in their first post-IPO year, and none of the 22 firms had a multiple in excess of 8. P/Es were generally above 9 for the Generators and Other companies, but spanned a wide range from about 6 to 15.

The multiple of 9 does not become more accurate in other years. Figure 6 shows that over the four

years following privatizations, company P/E ratios varied widely, ranging from about 4 to 18. Some companies, such as London Electricity PLC (circled in Fig. 6), varied both absolutely and relative to their industry. Few WASCs ever reached a P/E of 9. A P/E of 9 is not a credible floor for actual P/Es.



Sources: Datastream and companies' annual statements of accounts.

Figure 6. End of year average prices divided by trailing year net income for each company's Windfall Tax calculation period.

Additionally, I have never seen P/E ratios applied against four years of past earnings. They are typically applied against expected future earnings, and sometimes (as above) against the most recent year of trailing earnings if a forecast is not available. A long history of prior earnings (e.g., four years) is not appropriate for valuation since P/E ratios

themselves change considerably over such intervals. They become irrelevant to the historical earnings they would be multiplying.

Multiplying trailing earnings by a P/E ratio might be informative in cases where trailing earnings could be expected to continue or grow. But trailing earnings for the privatized utilities must have been partly transitory, because regulators were to reset rates and implement a new RPI-X rule at the end of the initial regulatory period.

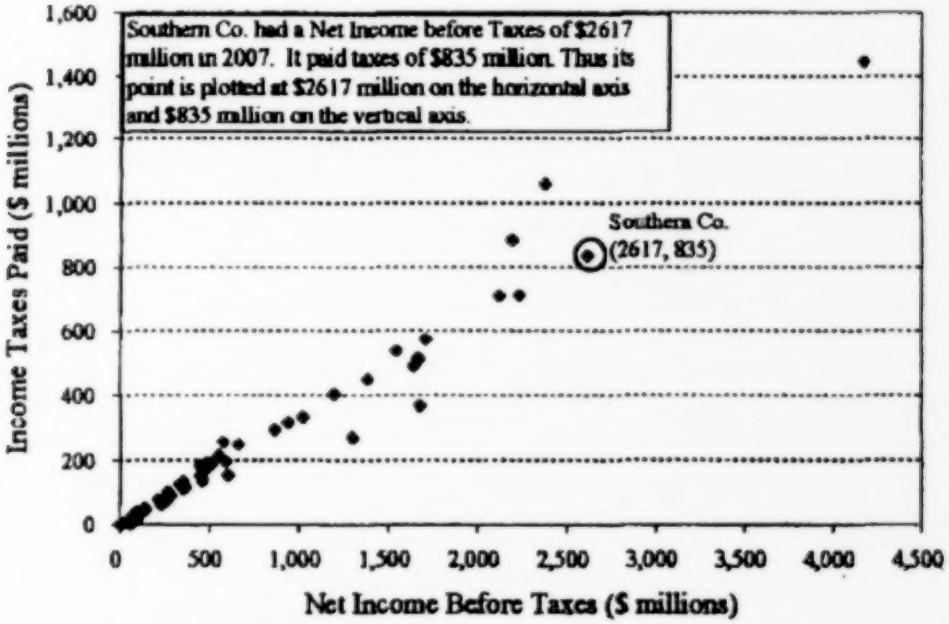
Since 9 is not an accurate P/E multiple, and it is not applied to current or expected future earnings, "value in profit-making terms" cannot measure the economic value that the companies could, would, or should have had.

V. EXPLAINING WINDFALL TAX PAYMENTS

A. Behavior of the Windfall Tax

The language of the Windfall Tax does not reveal its substance or character. The formula for "value in profit-making terms" does not correspond to any standard or rational method for estimating value. Therefore I have examined how the tax relates to several measures of economic performance in order to find its predominant character. If the Windfall Tax amounts are explained by the companies' market values, or by changes in their market values, then that is evidence of a tax on value. If the Windfall Tax amounts are better explained by the companies' profits, that is evidence of a tax on profits. It turns out that taxes paid are much better explained by profits than by value.

I use scatter plots to examine these relationships. I start with an example showing how the scatter plots work. Figure 7 plots the relationship between pre-tax income and corporate income taxes paid by firms in Value Line's sample of U.S. electric utility companies in 2007.[11]



Sources: Bloomberg and Value Line Investment Survey.

Figure 7. Income taxes paid by Value Line's sample of U.S. electric utility companies in 2007 plotted against their reported net income before taxes. The plot is close to a straight line, because net income before taxes is the target of

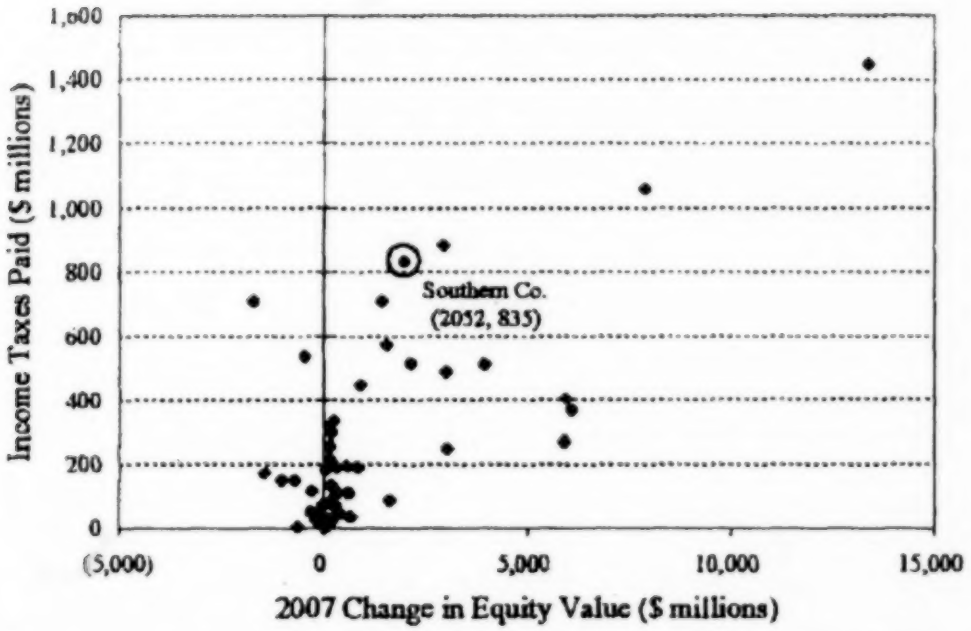
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[11] The Value Line Investment Survey is a widely used investment research service. Its industry groupings are often used in federal and state proceedings as a starting point for forming representative samples.

the income tax. The plot is not a perfect line because of differences in other factors such as tax credits.

The figure shows an upward sloping, nearly linear plot of the points. This is not surprising because for each additional dollar earned, a U.S. firm pays around 35 cents in additional income tax. The line also passes through the origin on the graph where both net income and taxes paid are zero. I will look for this kind of pattern in examining the U.K. Windfall Tax. Of course, the plot in Figure 7 is not a perfect line because other factors, such as tax deductions not reflected in book income, can change the income tax liability. Net income before taxes, however, is clearly the primary driver of the income tax.

Figure 8 plots those same income taxes against another measure of economic performance, as the annual change in equity market values. This change in value is not used by the IRS in computing income tax liability.

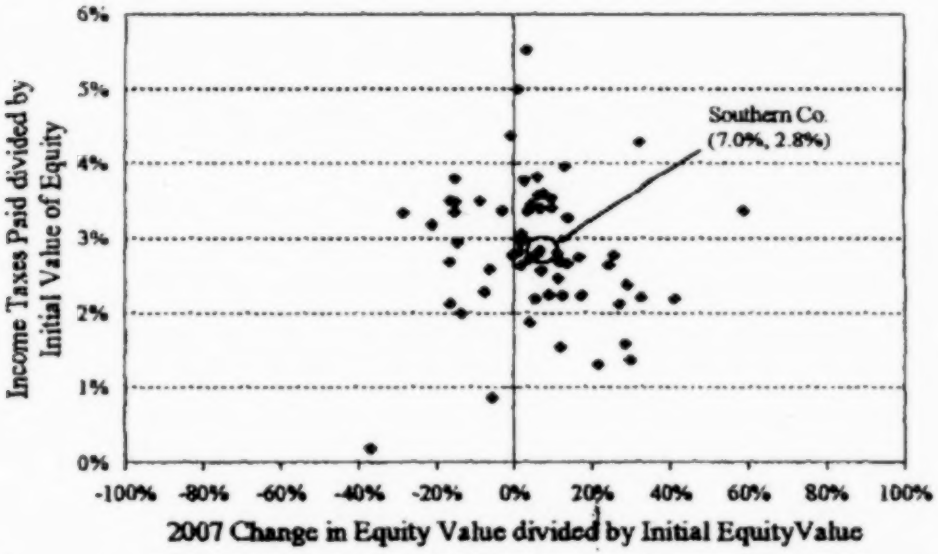


Source: Bloomberg and Value Line Investment Survey.

Figure 8. Income taxes paid by the Value Line sample of U.S. utility companies in 2007 plotted against their change in market value from the beginning to end of fiscal year. Compare the "fit" of this plot to prior Figure 7.

This is a far less coherent pattern. The hint of a linear relationship that appears in this figure reflects what is known as a "size effect." Small companies tend to have small value increases and small taxes, while larger firms have larger value growth and larger taxes. When large and small companies are plotted on the same graph without scaling for size, a superficially linear relationship between value and taxes paid appears on the graph, with small firms clustered in the bottom left and very large firms clustered in the upper right. I remove this spurious

relation by scaling the data values by some measure of firm size. This is done in Figure 9 using market value at the beginning of 2007 as the measure of size. Controlling for the size effect, any semblance of linearity disappears.



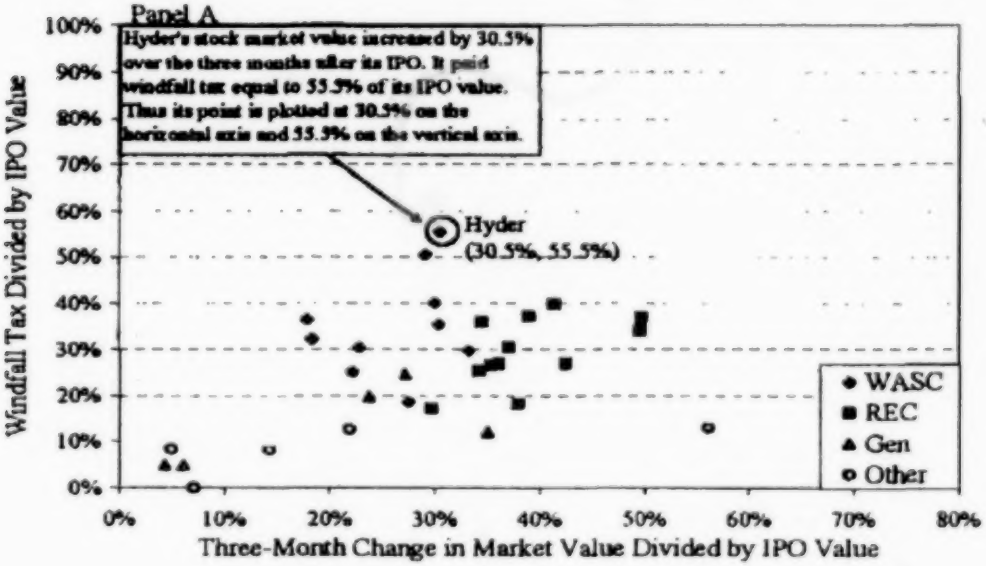
Source: Bloomberg and Value Line Investment Survey.

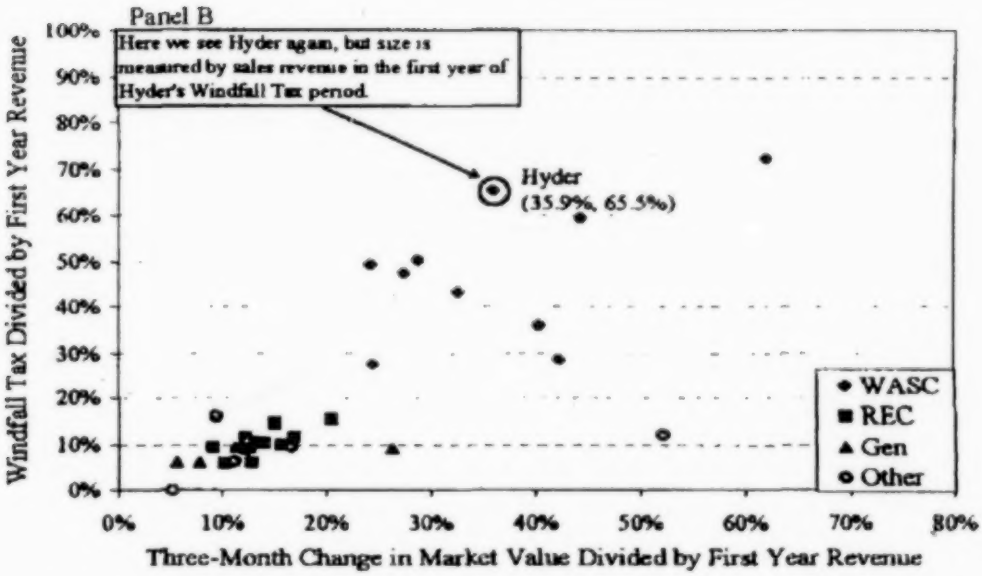
Figure 9. The same plot of income taxes versus change in the market value of equity found in Figure 8, but corrected for the size-effect by dividing income taxes and 2007 change in market value by the start of 2007 market value.

Now I show scatter plots for the Windfall Tax. Panels A and B of Figure 10 show the very weak relationship between Windfall Taxes paid by the privatized companies and the increases in the companies' stock market values over the first three months after their IPOs. Each point in the scatter corresponds to a particular company. For example, the circled point in each panel of Figure 10

represents Hyder, one of the WASCs. Hyder's stock market value increased by 30.5% over the first three months after its IPO. It paid Windfall Tax equal to 55.5% of its IPO value. Thus its point is plotted at 30.5% on the horizontal axis and 55.5% on the vertical axis in Panel A.

The difference between Panels A and B in Figure 10 is the measure of company size used to scale the data. In Panel A, size is measured by IPO value. Each company's value increase and Windfall Tax paid are scaled by (divided by) its IPO value. In Panel B, size is measured by sales revenue in the first year of Windfall Tax period.





Sources: Datastream, companies' annual statements of accounts, and Exhibit F, TAM Joint Factual Statement.

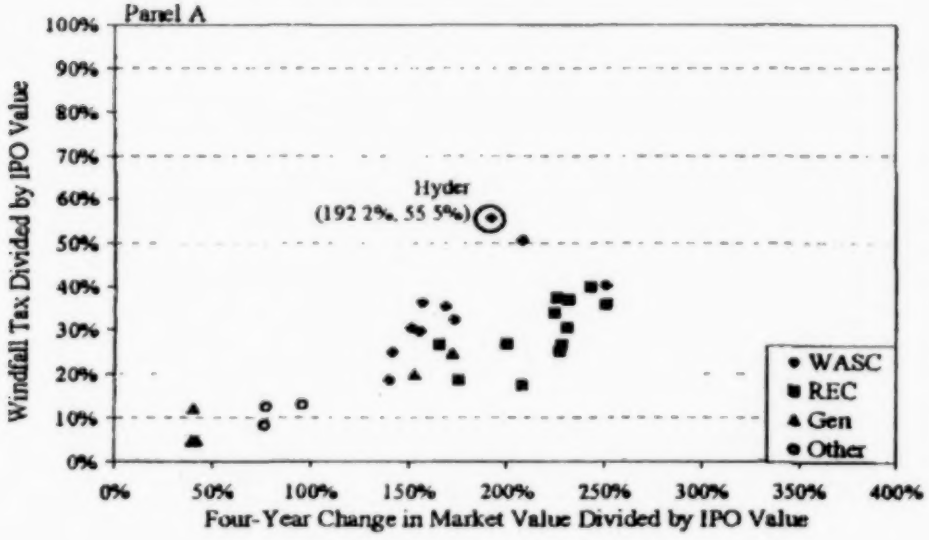
Figure 10. Relationship between the windfall tax and changes in market values at three months after IPO.[12]

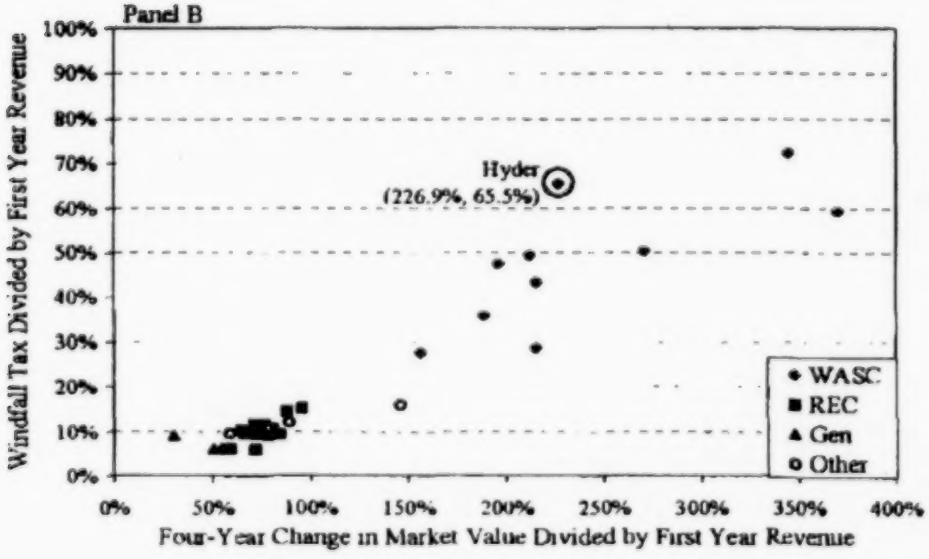
If the Windfall Tax were really a tax on initial undervaluation or on increases in value post-privatization, the points in Figure 10 would congregate tightly and reveal an upward-sloping line, as they did in Figure 7 for U.S. income taxes. The points do suggest a positive relationship between the Windfall Taxes paid and increases in market value,

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[12] Throughout the report, Windfall Tax liabilities and cumulative net income amounts are taken from Exhibit F, Schedule of Windfall Tax Liabilities provided by counsel for PPL Corporation and previously stipulated by the IRS as part of the TAM Joint Factual Statement.

but the relationship is loose and noisy, not tight. In fact, the relationship is probably spurious, because the general upward slope does not hold for the firms within the different industries in the plot.





Sources: Datastream, companies' annual statements of accounts, and Exhibit F, TAM Joint Factual Statement.

Figure 11. Relationship between the Windfall Tax and changes in market values at the end of each company's Windfall Tax calculation period. Comparing with Figure 7 the relation is very loose. This suggests that initial undervaluation is not what the Windfall tax is taxing.

Figure 11 focuses on whether the Windfall Tax is related to the changes in market value four years after privatization. By then, the high earnings of the companies had been revealed to the market, and stock values had climbed dramatically. However, the relation between the Windfall Tax and four-year changes in stock prices is only slightly stronger than the plots in Figure 10—and some of that is due to size effects that creep back into the data when size is normalized using just first-year data.

Now examine the panels in Figure 12, which are scatter plots relating differences in taxes paid to differences in net income over the four years after each company's IPO. Again, the point representing Hyder is circled. In Panel A, where net income and taxes are scaled by IPO value, the positive relationship is almost exact. This could have been predicted from the Windfall Tax formula. Nevertheless, Figure 12 illustrates an important feature of the Windfall Tax. After privatization, the *only moving part in the Windfall Tax machinery is net income.* All of the variation in taxes is strictly proportional to realized net incomes. If other factors

were affecting the tax, the linear pattern would be somewhat dispersed.

Panel B is the same as Panel A, except that net income and taxes are scaled by revenues in the year after privatization. Again a positive relationship emerges. The relationship in Panel B is not as clean or tight as in Panel A, but it is cleaner and tighter than in either panel of Figure 10 or Figure 11, which attempted to relate differences in windfall tax paid to changes in value. Moreover, the linear pattern holds within industries; it is not just a superficial effect.

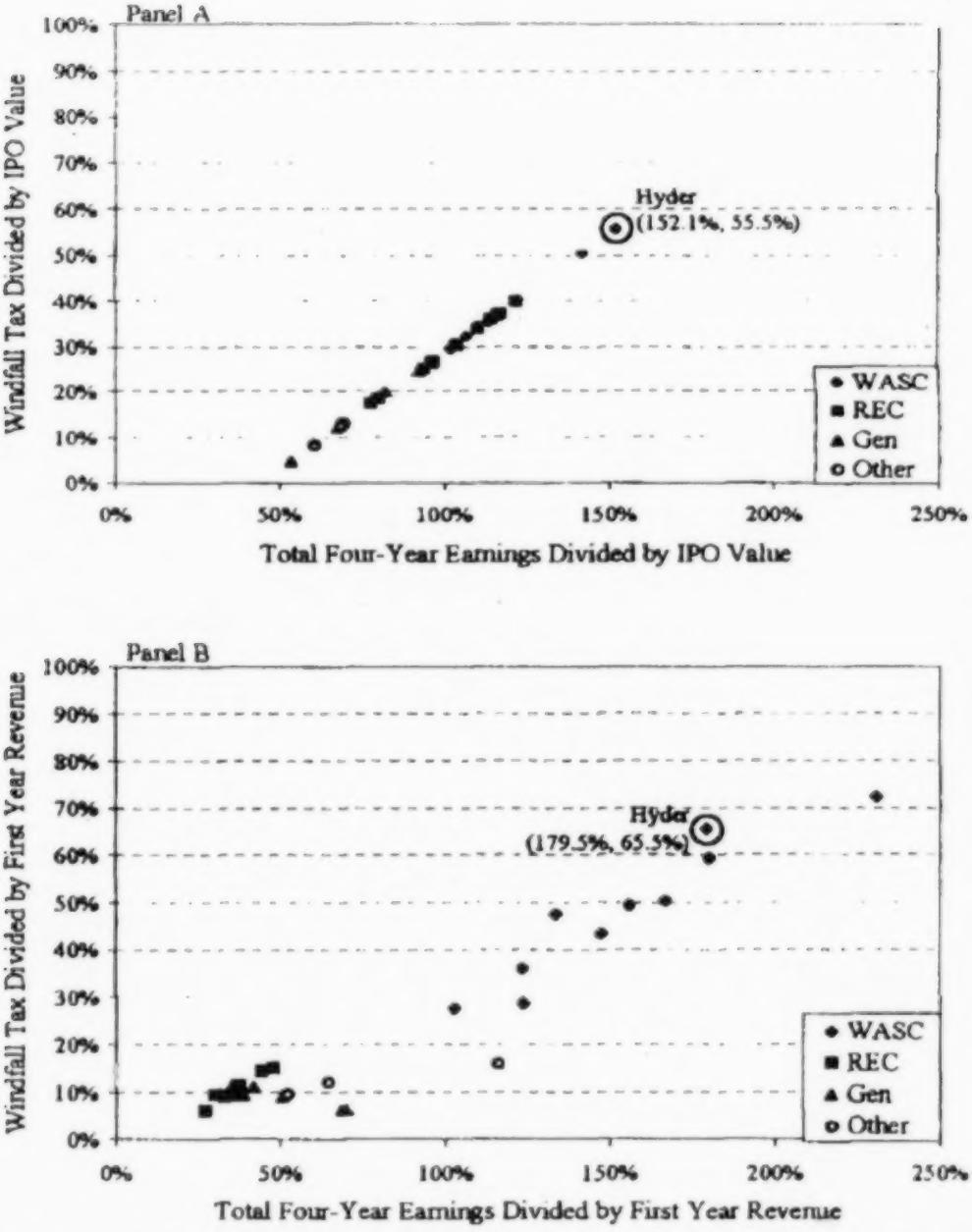
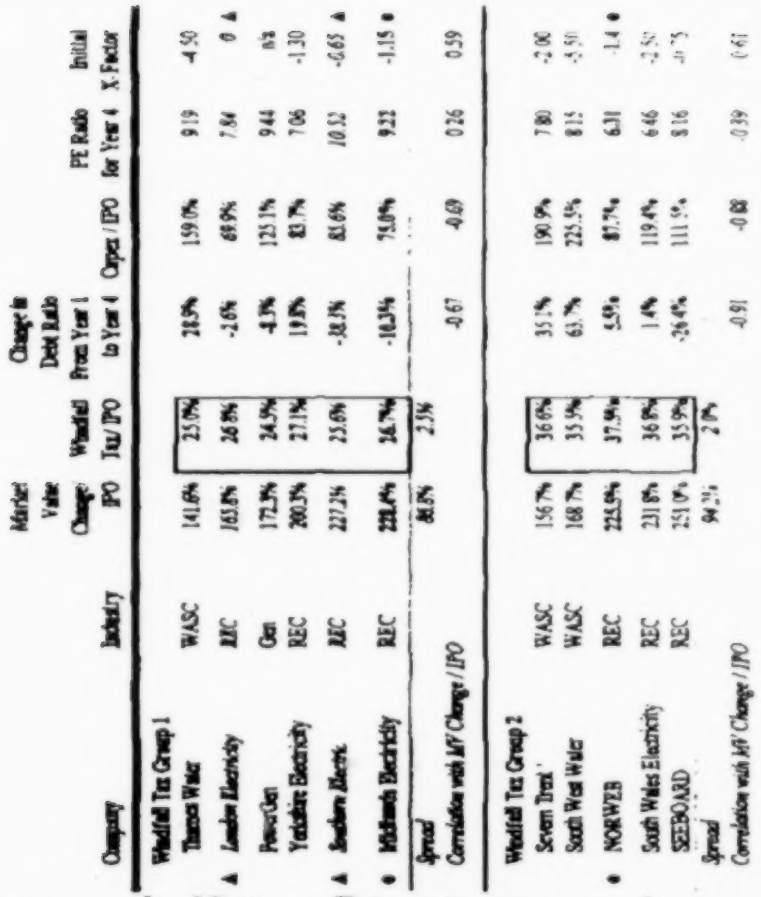


Figure 12. Relationship between the Windfall Tax and cumulative earnings over the Windfall Tax calculation period for each company.

B. Understanding the Behavior of the Windfall Tax

Figure 13 compares four-year performance of two groups of companies that paid Windfall Taxes. Each group contains companies with closely similar Windfall Taxes, scaled as a percentage of their initial IPO values. The first group had Windfall Tax obligations of about 25% to 27% of their IPO values, while the next group had about 36% to 37% of their IPO values. The companies in each group are ordered by their four-year change in stock market value. Each group contains a wide range of value appreciation, even though their Windfall Taxes were about the same. For instance, the market values of the companies in the first group appreciated by 141.6% to 228.4%. The second group's appreciation ranged from 156.7% to 251%.



Company	Industry	Market Value Change IPO	Windfall Tax/IPO	Change in Debt Ratio Price Year 1 to Year 4	Capex/IPO	PE Ratio for Year 4	Initial X-Factor
Windfall Tax Group 1							
Thames Wtr	WASC	141.6%	25.7%	28.5%	159.0%	9.19	-4.50
▲ London Electricity	REC	165.8%	26.8%	-3.6%	69.9%	7.84	0 ▲
PowerGen	Gen	172.3%	24.5%	-4.3%	123.1%	9.44	n/a
Yorkshire Electricity	REC	200.3%	27.1%	19.8%	83.7%	7.06	-1.30
▲ Southern Electric	REC	227.2%	25.6%	-38.1%	85.6%	10.32	-6.65 ▲
• Midlands Electricity	REC	228.4%	24.7%	-10.3%	75.0%	9.23	-1.15 •
Spread		86.8%	2.3%				
Correlation with MV Change / IPO				-0.67	-0.69	0.26	0.59
Windfall Tax Group 2							
Severn Trent	WASC	156.7%	36.6%	35.1%	190.9%	7.80	-2.00
South West Water	WASC	168.7%	35.5%	63.7%	225.5%	8.15	-5.50
• NORWEB	REC	225.9%	37.5%	5.5%	87.7%	6.31	-1.4 •
South Wales Electricity	REC	231.8%	36.8%	1.4%	119.4%	6.46	-2.5[illegible]
SEEBOARD	REC	251.0%	35.5%	-26.4%	111.9%	8.16	-[illegible]
Spread		94.2%	2.0%				
Correlation with MV Change / IPO				-0.91	-0.88	-0.39	0.61

Sources and Notes: Datastream and company annual financials.

Windfall Tax values computed in accordance with the Finance (No.2) Act 1997. X-Factors for the WASCs provided in *Future Charges for Water and Sewage Services: The Outcome of the Periodic Review*, OFWAT, 1995.

X-Factors for the RECs provided in *The Distribution Price Control: Proposals*, OFFER, 1994.

Figure 13. Four-year changes in Market Value for companies with similar Windfall Tax as

percentage of IPO value. Other factors that may explain value differences include debt ratios, capital-expenditures, and X-Factors.

The reason value can diverge so much across firms with similar Windfall taxes (and similar four-year average earnings) is simply that value depends on more than just recent past earnings. For instance, it also depends on how those earnings were achieved and how they were expected to grow. The regulated utilities were operating under RPI-X price caps that would not be adjusted for four to five years no matter how the company ran its operations or used its cash flow. If a firm chose to reduce capital expenditures, it would have more cash available to pay out as dividends (reducing earnings retained or reinvested) or to retire debt (increasing future earnings, because a recurring expense would be reduced).

Figure 13 reports that negative four-year changes in debt capitalization ratios (i.e., retiring debt) and low capital expenditures as a percentage of IPO value are correlated with higher market values. Another factor that is strongly correlated with value is the initial Xs. Larger Xs are correlated with larger growth in market values. This suggests the initial Xs correctly identified the companies most able to achieve efficiency improvements, but they underestimated how large those improvements would be.

This chart by no means exhausts the factors that can cause changes in market values to diverge from earnings. Other factors are also at work. For instance, the differing P/E ratios at the end of year four suggest differences in expected future business risks or earnings growth or risk.

In summary, two companies could have virtually the same Windfall Tax and very different values, such as London Electricity and Southern Electric (italicized "▲"), or virtually the same value appreciation but very different taxes, such as Midlands Electric and NORWEB (bold "●"). Value is not the economic dimension that was targeted by the Windfall Tax.

VI. THE WINDFALL TAX AS AN EXCESS PROFITS TAX

The scatter plots presented in Figure 10 through Figure 12 indicated that Windfall Tax payments are better explained by differences in net income than differences in value. This is good evidence that the tax was really an income tax, not a value tax. However, the patterns in Figure 12 do not pass through the origin. This indicates that the Windfall Tax does not fall directly on income, but on some adjusted measure that is less than total income. This adjusted measure is *excess* profits.

A. How Excess Profit Taxes Work

I reviewed the structure of several excess profits taxes that were imposed by the U.S. over the past century. They typically have had the form:

Excess Profits Tax = [Profits - Normal Profits] x tax rate

"Profits" are typically measured as after-tax net income of the business subject to the tax. "Normal profits" are typically calculated as some stated rate of return times invested capital, or as average earnings over some prior period in which corporate performance was deemed ordinary. Invested capital

is based on book values or is derived from stock market values at a particular date plus subsequent adjustments, such as capital expenditures or cash accruals. The tax rate may be a single number or a range of values, e.g., that step-up for higher and higher levels of excess income (progressive taxation). Figure 13 summarizes the basic parameters of four such taxes.[13]

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[13] In practice, additional refinements were commonplace in these taxes, such as exclusions or adjustments for certain kinds of intangibles and expenses, ceilings on the tax or on the tax plus ordinary income taxes, and other means of managing the incidence of the tax. Those elements are not essential for understanding the basic economic structure.

Country	Date Enacted	Base Period for Normal Profits	Profit Measure Taxed	"Normal Return" Benchmark	Tax Rate(s)
U.S.	1917	n/a	After-tax earnings	$5000 + 8% of equity capital	8%
U.S.	1917	1911-1913	After-tax earnings	Levels starting at 15% of invested capital	20% - 60%
U.S.	1933	n/a	After-tax earnings + interest adjustment	12.5% of adjusted declared value	8%
U.S.	1940	1936-1939	After-tax earnings	5% - 8% of capital, or 95% of average base period income	25% - 50% by bracket. 35% - 60% after 1941
U.K. Windfall Tax	1997	First 4 years post-IPO	After-tax earnings	11.1% of initial equity capital invested (IPO value)	51.75% for most companies

Sources: *Excess Profits Tax* , Revenue Act of 1917, Tit. II, 64th Cong., Sess. II, ch. 159. *War Excess Profits Tax,* War Revenue Act of 1917, 65th Cong., Tit. II, Sess. I, ch. 63. *Excess Profits Tax* , National Industry Recovery Act of 1933, Tit. II, 73rd Cong., Sess. I, ch. 90, sec. 216. *Excess Profits Tax Act of 1940* , Second Revenue Act of 1940, 76th Cong., Sess. III, ch. 757, secs. 710-752. *The Windfall Tax* , U.K.

Finance (No.2) Act 1997, ch.58, part I, Schedule 1, and Schedule 2.

Figure 14. Summary of select historical U.S. excess profits taxes compared with the Windfall Tax.

The last row in this figure above shows the equivalent algebraic formulation of the U.K. Windfall Tax. It has basically the same structure as the U.S. excess profits taxes. This is not a coincidence. The Windfall Tax is an excess profits tax. I reach this determination by developing an excess profits measure of my own, based on financial economic principles. I calculate the value of this measure for the RECs and the WASCs over their associated Windfall Tax periods. This measure is compared with the Windfall Tax liabilities of each of these utilities to help illuminate the predominant character of the tax. My analysis is restricted to the RECs and WASCs for two reasons: First, they were subject to the RPI-X pricing structure, which was a major cause of the controversy surrounding the excess profitability of the privatized companies. The Gencos and other privatized firms also had large profits, but through a variety of pricing mechanisms and market conditions. Second, the available data on the size and nature of the invested capital of the RECs and WASCs is more complete and consistent.

B. Windfall Tax vs. Excess Profits

Defining excess profits requires answers to two questions: "What is a normal return above which profits could be deemed excessive or abnormal?" and "What is the investment base against which the

normal returns are earned?" Financial economic theory provides a guide, in conjunction with a basic understanding of the regulatory mechanisms of the Water and Electricity industries at the time.

The basic economic concept for defining a normal return is the cost of capital. This is the expected return required for an investor to be willing to participate in an investment, after considering its level of risk. Utility regulators in many parts of the world use the estimated cost of capital when setting rates, so that regulated assets have a fair opportunity to earn profits commensurate with their risks. This ensures that financial capital needed for maintenance and growth can be obtained in a timely fashion on reasonable terms. It also protects consumers of the utility services from prices that might otherwise be set too high, if the utility were free to exploit the natural monopoly it enjoys over its service territory.[14]

Typically a utility also has a well-defined base of productive invested capital that is eligible to earn an allowed return, which in the U.S. is called the "rate base." Not all invested capital is part of the rate base for three reasons. First, some of the capital may be invested in assets that are still under construction and not yet productive. It should not be expected that

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[14] In many countries, the regulated company's fair opportunity to earn its cost of capital is a legal requirement for allowed rates. For example, in the U.S. this practice is viewed as consistent with the U.S. Supreme Court's opinions in *Bluefield Waterworks & Improvement Co. v. Public Service Commission*, 262 U.S. 678 (1923), pp. 692-693, and *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1944), p.603.

these would yet earn a return. Second, some capital may be invested in unrelated lines of business and should be excluded. Third, some assets may be purely financial holdings that earn their own returns directly. These are usually excluded from the rate base.

I understand that it was infeasible to calculate the fair value of the initial, productive capital of the U.K. privatized companies (especially the WASCs) from their book values. This is primarily because of the nature of their record-keeping, since many of their assets were very old. However, the market values of these companies shortly after the IPOs showed how investors valued the stream of expected profits from the productive assets under RPI–X pricing. These early values, with adjustments for future investments, became the regulatory asset bases (RABs) for future regulatory review and repricing of the services of the privatized companies after the initial rate-setting period.[15] At the first reset of the RECs' and WASCs' prices, OFFER and OFWAT took the same basic stance. They decided that the equity portion of regulatory capital would be tied to the IPO market value, while debt capital would be valued on a current cost basis. I therefore use the equity portion of those RAB values to

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[15] The RAB is also called Regulatory Asset Value (RAV) by OFGEM (previously OFFER) and Regulatory Capital Value (RCV) by OFWAT.

measure invested capital in my excess profits calculation.[16]

OFWAT and OFFER also estimated the costs of equity capital. Both the WASCs and RECs were viewed as having an after-tax real cost of equity somewhere between 5% and 8%.[17] This is consistent with security analysts' comments on expected returns at the time, so I have used costs of equity of 5.5% (WASCs) and 6.75% (RECs) as my thresholds for normal profits. These values are equivalent to 10% to 11% in nominal terms, given the average RPI inflation levels of 5.2% to 3.4% in 1990-1994 and 1991-1995 respectively. Such values are consistent with Brattle's own analyses and experience with cost of equity estimates for U.S. utilities around that time frame. These values are quite close to the implicit annual return of 11.1% on IPO value I derived in the algebraic restatement of the Windfall Tax. However, that result is coincidental, since my calculations of excess profits do not come from the Windfall Tax parameters.

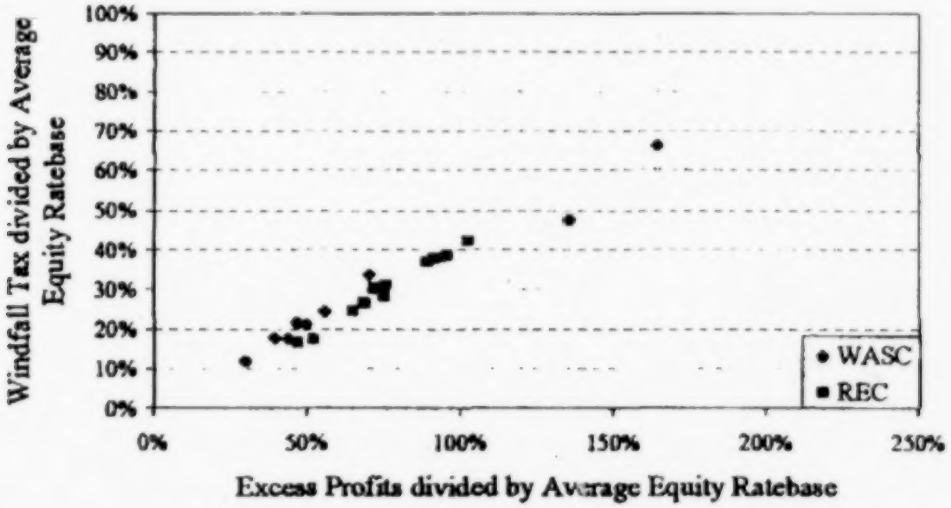
Regulatory reports from the price control reviews contain the regulators' computation of the regulatory asset base for each of the WASCs and RECs in each of the Windfall Tax years. I computed the equity portion of those RABs for each of these years. These

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[16] Since these RAB values were used by UK regulators to reset prices, they provide the natural and appropriate basis for the "invested capital" in my excess profits calculation.

[17] See, for example, *Cost of Capital, A Consultation Paper Volume 1*, OFWAT, July 1991 and *Northern Ireland Electricity plc". A report on a reference under Article 15 of the Electricity (Northern Ireland) Order 1992*, MMC, March 1997.

values were multiplied by the costs of equity (5.5% or 6.75%) to determine normal annual profits for each company in the Windfall Tax periods. This amount was deducted from actual after-tax earnings to compute an annual measure of the excess profits. Figure 15 depicts the cumulative level of these excess profits against the U.K. Windfall Tax for each company (both normalized for size).[18]



Sources and Notes: Datastream, company annual statements of accounts, and Exhibit F, TAM Joint Factual Statement. Reviews of Public Electricity Suppliers: 1998 to 2000 , Price Controls and Competition Consultation Paper, July 1998, OFGEM. 1994-95 Report on the Financial Performance and Capital Investment of the Water Companies in England and Wales, OFWAT.

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[18] These are normalized by average estimated equity value over the Windfall Tax years for the same reasons as in earlier graphs.

Figure 15. Relationship between the Windfall Tax and cumulative excess earnings over the Windfall Tax period for each company. I control for size by dividing by average equity RAB over the Windfall Tax period for each company.

The tight, linear pattern in this chart demonstrates that the Windfall Tax behaves as an excess profits tax, increasing directly in proportion to excess profits. It also is close to zero when there are no excess profits. If the Windfall Tax had been specified as a tax on earnings in excess of computed normal profits, it would have fallen on the WASCs and RECs in almost the exact same way it fell on them under the nonconventional [Value in Profit-Making Terms less IPO] × 23% formulation. Of the alternative performance measures I have evaluated (initial IPO appreciation, four-year change in value, earnings, and the excess profits depicted in Figure 15), the excess profits measure has the best relation to the Windfall Tax. This is not surprising, as the Windfall Tax is algebraically equivalent to such a tax. I have now demonstrated that fact empirically without any reliance on algebra or on the terms of the Windfall Tax legislation.

VII. CONCLUSIONS

The language of the U.K. Windfall Tax does not reveal its economic substance or character: Was the tax directed at profits or value? That question is best answered by evaluating how the tax actually behaved. When the Windfall Taxes actually paid by the privatized companies are compared to changes in the companies' market values, no coherent pattern

emerges. When the Windfall Taxes are compared to the companies' net income, there is a good linear relationship. The relationship is especially tight when Windfall Taxes and income are scaled by IPO values. This should come as no surprise: after the companies' IPOs, the only moving part in the Windfall Tax calculation was net income.

I then measured excess profits for the companies using standard financial and regulatory principles. Those excess profits explained Windfall Taxes almost perfectly, which confirms that the tax is really an excess profits tax. Again this is no surprise, because the Windfall Tax formula is algebraically identical to the formula for a standard excess profits tax.

The Windfall Tax legislation refers to "value in profit-making terms," defined as average past profits multiplied by a P/E ratio of 9. This ratio is arbitrary and inaccurate. Actual P/E ratios for the privatized companies varied widely. Initial P/E ratios for the WASCs and RECs were all below 9. Later P/E ratios for these and other companies also varied widely.

Multiplying past earnings by an arbitrary ratio of 9 cannot give economic value. Economic value is forward-looking. Valuing a company based on four years of past earnings, which were known only with hindsight, makes no economic sense, especially when regulators were about to intervene and constrain future earnings.

If the U.K. government had wanted to measure value or changes in value, it could easily have done so. The privatized companies were valued daily on the London Stock Exchange. The designers of the

Windfall Tax could have used stock-market values to identify (with hindsight) the "undervaluation" of the companies on or after their IPO dates. Instead they settled on a formula in which the chief moving part is not value but profits. The Windfall Tax was a tax on profits, specifically on excess profits.

[Appendix omitted in printing this appendix]

EXHIBIT 145-P

UNITED STATES TAX COURT

Docket No. 25132-06

ENTERGY CORPORATION AND AFFILIATED SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BEFORE: Judge James S. Halpern

Testimony of Geoffrey Robinson

April 7, 2008

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* * *

[58]

Whereupon,

GEOFFREY ROBINSON

having been duly sworn, was called as a witness and was examined and testified as follows:

THE CLERK: Would you please state your name and address for the record?

THE WITNESS: Geoffrey Robinson, Orchards at Munstead Heath Row, Godalming, Surrey, England.

THE COURT: Did the reporter get that? The address?

THE WITNESS: Orchards at Munstead Heath Row. Would you like me to spell it?

THE COURT: Do you want him to spell it?

THE REPORTER: Sure.

THE WITNESS: Munstead, M-U-N-S-T-E-A-D

Heath, H-E-A-T-H, Row, Godalming, G-O-D-A-L-M-I-N-G, Surrey, S-U-R-R-E-Y, England.

THE COURT: Thank you very much. Mr. Gardner, am I going to need these books or can I move them out of the way?

MR. GARDNER: You may, Your Honor, because I don't think you'll need them.

THE COURT: It blocks my view of the witness.

MS. ARNDT: Your Honor, before Mr. Robinson gets started, I'm uncertain whether he's calling Mr. Robinson as a tax witness or an expert witness at this time.

MR. GARDNER: Well, we're calling him as a tax witness, and we're just going to introduce the expert report to get that out of the way.

THE COURT: He'll introduce that as marked up, and then he can proceed to ask him the fact questions because otherwise he'd rest.

MR. GARDNER: I have to get the report in and then

MS. ARNDT: Okay. Thank you. I just didn't understand. Thank you.

MR. GARDNER: His testimony will all be facts well within his introduction as to where he was educated and that sort of stuff. May I begin, Your Honor?

DIRECT EXAMINATION

BY MR. GARDNER:

Q Mr. Robinson, would you tell the Court your educational background?

A I was educated at secretary school in London. I won an open scholarship to Cambridge University. From Cambridge I was awarded a Mellon fellowship to Yale University where I studied for two years.

THE COURT: Did you say Yale?

THE WITNESS: Yale.

THE COURT: Yale.

THE WITNESS: I did a composite course and graduated with an M.A. from Yale University.

MR. GARDNER: Thank you.

MS. ARNDT: Your Honor, Respondent has no objection to Mr. Robinson being offered as an expert witness with qualifications on the enactment of the windfall tax, which is what Mr. Gardner represented to us during the break, that that's what he planned to offer Mr. Robinson as.

THE COURT: All right. I understand.

MS. ARNDT: Okay.

MR. GARDNER: I'm attempting to show the Court Mr. Robinson's qualifications.

THE COURT: Well, they're also attached if I remember correctly.

MR. GARDNER: They are. It'll be brief. It'll be quite brief.

THE COURT: You have some latitude to do it.

MR. GARDNER: Yes. I think it will go rapidly.

BY MR. GARDNER:

Q Could you briefly describe the positions you've held since graduating from college, Mr. Robinson?

A I went first to work for the Labor Party in the Research Department. I then went to as a senior executive to an organization called the Industrial Reorganization Corporation, which was set up by the government to promote efficiency in industry. I was then recruited from there to be Financial Controller of British Leyland, a massive U.K. car manufacturing industry in those days.

I became successively Financial Controller, then Managing Director of Innocenti, their subsidiary in Italy, and went back from there to become the Chief Executive at Jaguar Cars from where I resigned following a disagreement with them about the future course of the British motor industry.

At around that time, 1976, sadly, the then Member of Parliament for Coventry Northwest died, and I was invited to stand for that seat, which I have successfully defended in about eight general elections since then.

Q And you were elected to the House of Commons. Could you briefly describe your areas of responsibility in the House of Commons from 1976 until 1997?

A We lost the 1979 election. Lady Thatcher was Prime Minister. Thereafter, I served as a shadow spokesman successively again in science, the regions and industry. I resigned from where I was assigned, I was unhappy with party policy at that time, and from then which I rejoined the Gordon Brown's research team in 1994 in preparation for the election which took place in 1997. It was that period in which, amongst other things, the work on the windfall tax was done in opposition

Q Could you just describe briefly the role that you played from conception to enactment of the windfall tax?

A Well, the conception falls with Gordon Brown himself in 1993 where he promised a windfall tax off the excess profits of the privatized utility. By 1994, it became a regular feature in all our parties' speeches and programs leading up to the manifesto in the election.

It seemed to me that it was becoming a critical point of credibility for the Labor Party to form the new government, and I made suggestions then with my knowledge and experience in industry which perhaps other members of the research team didn't have. But if we wished to make it a very serious proposition to the government, we should do proper work, preparatory work for it.

I suggested we took their full professional advice, which we did and which sewed us well when we came to enact the tax itself.

Q Could you briefly describe the role you performed as Paymaster General?

A Well, I was charged following being charged by Gordon Brown in opposition, who went to be Head Chancellor, he asked me pretty naturally enough since I had been leading the research work into it in opposition to take the lead role in piloting through Parliament the windfall tax. I had other quite significant responsibilities at that time, but that was our flagship program for the windfall tax on the privatized utilities' excess profits. That was our windfall. That was our flagship program, sort of first budget, which became known as the 1997 No. 2 Finance Bill.

(Sound fading.)

MS. ARNDT: Your Honor, Respondent's counsel is having a little bit of difficulty hearing Mr. Robinson. I don't know if it's the way he's facing.

THE COURT: Are our microphones here amplifying or are they just recording? His microphone.

(Discussion held off the record.)

THE COURT: The last one was dates. The dates were of the windfall tax—

THE WITNESS: 1997 No. 2 Finance Bill.

THE COURT: Did you get that? By the way, if you have a problem, just put your hand up and I will get him to repeat it.

MR. GARDNER: I would like to offer Mr. Robinson as an expert on the enactment of the windfall tax portion of the Finance Act No. 2 of 1997 and its history.

MS. ARNDT: No objection, Your Honor.

THE COURT: So received as an expert.

* * *

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BY MR. GARDNER:

Q Mr. Robinson, did you serve in the House of Commons from 1976 to today?

A I did.

Q Were you a member of the House of Commons when these companies were privatized?

A I was.

Q Did you participate in the various debates in the House of Parliament that dealt with the privatization?

A Yes.

Q Do you have an understanding as to why they were privatized?

A I do.

Q Could you tell the Court your understanding?

A There were two principal reasons. Conservative governments, like all governments, needed money and could see privatization to bring funds in. Secondly, they regarded it as part of their program for promotion of efficiency in British industry.

Q And could you describe your reaction to these privatizations when they occurred? A My personal reaction as a labor politician was in not all of them could I see any need for that, particularly in the large private utilities, and then as that was in principal, I had an ideological objection, which was felt in various degrees throughout the Labor Party at that time. In practice, fears proved to be—

MS. ARNDT: Objection, Your Honor. He's talking about our fears. He's not speaking about his own fears.

THE WITNESS: My fears.

THE COURT: The question was what was his reaction.

MS. ARNDT: And he answered going beyond what his reaction was as to what the fears of Parliament I guess were.

THE COURT: I think on cross-examination if you feel it's unclear, you can get to it. I'm going to overrule your objection.

MR. GARDNER: You may proceed, Mr. Robinson.

THE WITNESS: I can be happily corrected there by saying my fears were that it would prove to be that these companies were in effect ripping off the public, and hence, my concern grew that the level of profits they were making were excessive. And by 1993, it had reached the point where I viewed, and I have to now switch to somebody else's view I'm afraid, there's a Chancellor-to-be, the shadow Chancellor, who put forward a program whereby we would tax those

excess profits and use the funds to finance public works in the name of a youth employment program.

BY MR. GARDNER:

(Electronic interference.)

Q I'd like to take you back to that period. You mentioned 1993. I'd like to take you back to 1994 through 1997 when the Labor Party was in opposition. Could you tell me what involvement you had with the Labor Party's treasury team, and maybe begin by telling us what Labor Party's treasury team is because the Court may not know that?

A It's a shadow team, we called it, which shadows the actual government itself. And the leader of our shadow treasury team was Gordon Brown, who we recognize is now the Prime Minister. When he lost the leadership election in—

* * *

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MR. GARDNER: I think you were explaining to the Court what a shadow treasury team is.

THE WITNESS: It's a team that Her Majesty's opposition set up to shadow the actual government team, so we're shadowing the treasury.

Our leader, shadow Chancellor, was Gordon Brown, who when he lost the 1994 leadership election following the sudden death of our previous leader to Tony Blair, Tony Blair became leader. Gordon Brown remained shadow leader, at that point, he asked me to join the shadow team not in an

official capacity as a shadow member but as a part, an integral part of the research team that he had set up to work through the plans we had in opposition for their implementation in government.

BY MR. GARDNER:

Q Could you describe for us the role in connection with the formulation of the windfall tax contained in Finance Act No. 2 of 1997 that you had?

A Well, as I said, Gordon Brown, who made this a principal part of our policy with early speeches in '93, it seemed to me, with some experience in these matters, I sat on various finance bills earlier as a backbencher, if we were to get it through government, we needed to do proper research work on it. I therefore felt that we would need the benefit of specialist advisors. And I didn't commission, but I recommended that we commission those in respect to accounting and the legality of the tax.

Q Were there any prior taxes enacted by the Parliament when the conservatives controlled the government that offered you guidance in formulating this tax?

A One of the early things we asked Arthur Andersen, who we went to for the advise on the accounting, as to what were the precedents. Of course having been in the House for a long while, and others had, too, we knew there were a couple, and we guided them to those. One was the petrol revenue tax, the tax on petrol revenues.

The other one was the banking tax on bank deposits. I think the dates where they occurred, one

was established before petrol revenue, was the most recent examples we had for the runoff nature of what they were doing was in 1981, petroleum revenue, and 1983 were quite novel, new tax on banking deposits introduced in 1983.

Q What instructions—well, you've made reference but maybe make it clear, did you retain advisors at that time?

A Yes, we did. We sought advice from Arthur Andersen and from—

Q You had retained Arthur Andersen to advise your group that was working on it?

A Yes, indeed.

Q And what did you tell your advisors to do?

A Well, we gave them a purpose of the tax and what we were setting out to do, which was to tax the excess profits of the privatized utilities. We asked them to come up with in accounting terms an arrangement for doing so, a mechanism you could call it, a basis for doing it that would meet Parliamentary requirements on the one hand, would be obviously sustainable by the companies, would meet Parliamentary requirements as far as the legality went, which was a separate issue, but would meet U.K. law and our commitments under EC law.

Q And why did you tell your advisors to proceed that way?

A Because we wanted to make sure that the tax would give us the amount we needed in a way that was acceptable, manageable by the company and acceptable in Parliamentary terms.

We needed specialist advise on that because there could be many alternative ways of doing it that would not give us the result we wanted or would pose other problems that would cause us difficulty either in the Courts outside Parliament but inside Parliament as well.

Q Did Mr. Brown give you instructions or objectives that he wanted to accomplish?

A Yes. He told me that in addition to what I've just said—

MS. ARNDT: Objection, Your Honor. Hearsay.

MR. GARDNER: It's not hearsay, Your Honor. The conversation between Mr. Brown and Mr. Robinson is not hearsay. Hearsay, under Rule 801, is a statement—

THE COURT: Out of Court statement offered for the truth of the matter.

MR. GARDNER: The truth of it. We're not offering it as for the truth of anything other than that a conversation occurred between Mr. Brown and Mr. Robinson, Mr. Robinson participated in it. The truth that we're getting to is the conversation existed and what he, Mr. Robinson, was told by Mr. Brown.

That rule has been very clearly interpreted by the Fifth Circuit to permit that type of a dialogue to be admitted, and it is not even hearsay. In the case of National Labor Relations Board v. Tex-Tan, Inc., which can be found at 318 F.2d 472, in discussing a conversation between parties that took place, a witness who was there can testify to the conversation

and what he was told. That is going to the truth of what Mr. Brown said.

THE COURT: Well, I think the existence of a conversation is not hearsay, but if you're going to make a proposed finding of fact on the basis of what he was told that would be hearsay. So why don't you hold your objection. You can remake it after we hear what the reported conversation's going to be. I don't know what he's going to say yet.

MS. ARNDT: Okay. Thank you, Your Honor.

THE COURT: You can stay standing if you'd like.

(Laughter.)

MS. ARNDT: I'll sit.

THE COURT: Just continue, and then pop up when—I need to understand what the purpose of the conversation is.

BY MR. GARDNER:

Q What instructions were given to you by Mr. Brown?

A To make arrangements, proffer a plan, a formula, for the imposition of the tax on the privatized utilities' excess profits that they made since they were privatized, a tax on those profits. We had to find a way. So he instructed me. Quite clearly that was my job in opposition and became my job in government.

MS. ARNDT: I object, Your Honor. I mean, I need to strike that last statement about what exactly Mr. Brown told Mr. Robinson.

THE COURT: But, again, you're offering it only for the point that he was given instructions.

MR. GARDNER: He was given those instructions, Your Honor. That's all I'm offering it for.

THE COURT: I'm going to overrule your objection.

MS. ARNDT: Thank you.

BY MR. GARDNER:

Q Now did you then give instructions to Arthur Andersen?

A Precisely those instructions, yes.

Q So you conveyed—

A But we also gave some legal advice as well. Those were the instructions Arthur Andersen got, and they made several different sets of proposals for achieving that end.

Q Now could you take us through the proposals that were given to you by your advisors to accomplish this objective?

A Yes. There were six of them altogether. I can list them in no particular order as I think they perhaps occur to me. One was a straightforward tax on turnover, the precedent there being the petroleum revenue tax. Next one would be a tax on assets, and there, the bank might have come in in that sense.

Third one could be a tax on excess shareholder returns, and we considered that, too. It could be a tax strictly on profits, and there are certain problems attached to that. One, we're in a sense most clearly

targeting, could have been tax on excess profits. It had problems. They all had problems.

Then we had the one we in the end decided was the best without ruling out any of the others, was the tax on the difference in the flotation price and what the subsequent excess profits had shown. That was the driver for it. The companies will really work.

Q Could you briefly tell us why you rejected each of the other five options that were given to you by Arthur Andersen?

A Well, if I go to the main point in each case it would be on turnover, you see, we didn't really—

* * *

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BY MR. GARDNER:

Q And if you would take each of the alternatives that you told us a moment ago—

A Yes. I think I was up to the turnover, and then I—

Q You had started with the turnover and told us why—

A And really the direct correlation wasn't a very good proxy for the excess profit that we're targeting, and there had to be the best correlation, the best proxy we could get.

Some of the assets didn't do that for us, so you could see a more direct relationship perhaps there, and we had the president of the banks who said it

was a tenuous relation. It didn't really target the profits in the way that we were intending to do.

Then there came shareholder returns, which got nearer to it, but there were several problems relating to that, not the least that the government as an opposition, we had already pledged ourselves in government not to raise personal rates of taxation. To target the members of the public, the shareholders, it would be seen as a breach of that undertaking in our manifesto.

Secondly on the shareholders, we would probably be targeting the wrong ones, those who had cashed in in the early days and for a few years wouldn't necessarily have been the shareholders when we came to impose the tax.

Thirdly, it would be very difficult to find those shareholders. What about the overseas shareholders? We hadn't dealt with that. So there was a whole string of difficulties. Although it was getting nearer the concept of excess profit, it was still not good enough.

We could have taxed the profits themselves. I think I'm at four now. And that had the obvious rationale of being part of the target we were looking at. We were really going for the excess profits. The problem there would be that in principle it would be seen to be taxing the same profits twice, which wasn't a very good thing to do, and if we levied it at the rate to reach the target we had, which had been set by Gordon Brown, and he gave me the job of doing it. We set the target for the advisors of $5 billion.

It would mean some company, because we couldn't discriminate between them. Parliamentary regulations had to impose the same tax run on each one of them. It would have been very badly hit and so that was attractive in principle. The rationale was good.

The fifth one that had the best rationale is excess profits. The difficulty there would have been, and don't forget, we were here getting very clear-cut advice from a top firm on this, that once during the war, and I think this was referred to earlier on in hearings today, we had had a tax on excess profits. This would be taking us back to what new Laborers, we were fighting the election on, precisely what we'd been elected on.

It was not at all the image, the perception that the government wanted to portray to go back to that, and we wanted it as a one-off tax (phonetic). So, if you went into a tax on excess profit in relation to something else, you'd have to decide what the excess was, what rate the tax was. But then on top of that how you could enter into a permanent statutory organization of our taxation system, which we didn't want either.

So for those reasons, we were in some difficulty really on an excess profits tax as well, and again, it could have impacted quite variously on the different companies involved and could have impacted very severely on perhaps even the very survivability of some of them, so that posed those series of questions.

Then we came to the sixth alternative, which was put out by Arthur Andersen, and it seemed in

itself it didn't present any of those problems that in the varying ways had affected the others.

For example, on the excess profits there, British Gas would have been excluded. It was a massive exception to the whole principle of what we were trying to do. On excess shareholder returns, British Telecom, a massive company, became the single biggest contributor to the tax, would have been excluded. So we now had a formula under six which was—

Q Excuse me. Did you say would not have or would have been excluded?

A No. Under I think I took it as the third one, the excess shareholder returns, British Telecom, which was our single biggest target, and it turned out to be quite rightly our single biggest contributor, would also have been excluded.

So I'm saying these were the general and also the specific practical difficulties of the previous five, none of which presented themselves when we got down to examining the sixth one where we took the subsequent profits as adjusted by the much higher share price and much higher potential capitalization on floatation. Then the actual price such as it had been, each individual company had actually been floated out.

And this one gave us a formula or a mechanism whereby we could fix the price earnings ratio such as the yield, give us the yield we wanted, a common tax rate such as the yield we wanted. We had a common—this is a very important Parliamentary point here. You mustn't differentiate between

different categories of taxpayers within your given group. We defined the group as being under the sixth proposal of privatized utilities who had been subject to regulation. I can explain the significance later if you'd like of that.

And here with this one we could have a common price earnings option, a common tax rate. The companies could afford it, and we believed and the difference we had between the price floatation that was actually charged and the price of the subsequent excess profit clearly justified, we had a pretty good proxy for those profits themselves, had a good rationale, a good explanation in general principle but also something that worked in practice with the Parliamentary procedures.

And as far as we could judge, we had very good legal advice from the U.K. Regulatory Parliament and EC and ECHR, the European Court of Human Rights, requirements as well.

Q You mentioned a moment ago that you could explain a little further the effect that regulation had upon—

THE COURT: Yes.

BY MR. GARDNER:

Q —the privatized companies as a driver or a factor. Could you spend a moment on that?

A Well, we could see that when you privatized these companies, the conservative government saw in the process of privatizing them that you're actually going to create fairly large monopolies who could abuse their monopoly power.

And they therefore set up regulators to ensure they wouldn't, particularly on price, but it also relates to service as well. And so they put in a regulator who was meant to see that they didn't, but the regulation, as generally is recognized to be the case, was very lax in the early years, and that contributed to the excess profits as well.

Q So, in a nutshell, Mr. Robinson, could you tell us why it was that you basically selected this sixth option, which is what eventually became the windfall tax as enacted by Parliament?

A Because it avoided all the problems of the other five and because it gave us a flexible formula or a flexible mechanism that could be seen to hit the excess profits that have driven this difference, the driver of the excess profits.

It had a good correlation so that was a good proxy for that, avoiding the problems of the other five proposals, and indeed on the figures we had there, which certainly in our position were all subject to testing by the government's database, one of the figures we had then showed that the companies could afford it, which was not the least of our concern.

MR. GARDNER: I have no further questions, Your Honor, and I pass the witness.

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BY MR. GARDNER:

Q Mr. Robinson, you were asked by government counsel about British Gas—

A Yes.

Q —not being subject to tax if it had been, I think in the original testimony, a straight simple excess profits tax. Could you expand on that because she sort of cut you off? Could you explain what you were saying?

A In the period, the first four years after we took the period we passed on the definition of the "qualifying company," British Gas had not made an increase in their profit level. It was a mystery to us because every other aspect of their business has increased very handsomely because the shareholders, share price, remuneration generally. So it, however, did not on the fact of it show an excess profit. And we had difficulties, as I said before, in defining—we would have had difficulties in defining what an excess profit was.

If you would take it simply in terms of profit increase over the level they had before privatization and what they had in the first four years of privatization, if you took it simply like that they would not have qualified as generating excess profits.

But their profits throughout, as I said, were very high, could have no doubt been considered excess, but by a simple application of that formula they could have made the case that they did not qualify, they were not a qualifying company.

Q Now you still have in front of you your book?

A Yes.

Q And earlier you were asked about whether you made reference to taxing excess profits when you

were dealing with Arthur Andersen. Could you turn to page 67 of your book?

A Yep.

Q Could you look at the second full paragraph, the third sentence.

A Of which paragraph?

Q The second full paragraph on page 67.

A Yes. There can be no retreat.

Q The last sentence that begins "no speech."

A Yes.

Q Would you read that, please?

A "No speech of Goldman's (phonetic) is complete without reference to utilities, the fat cat and the excess profits to fund the youth training program."

Q Now would you turn to page 72 where you are discussing—I will try not to read it all—you are discussing in general what was going on and you are talking about the people who were charged with the responsibility of designing the taxes. Would you look at the very last sentence of the carryover paragraph on page 72, would you read that please?

A "That stops the excess dividends," is that the sentence?

Q No, the one that says, "Moreover, the excess profits concept."

A On page 72 and I'm looking at the first—oh

Q The carryover paragraph.

A Oh, the carryover paragraph, "moreover." "Moreover, the excess profits concept fitted well with Goldman's fat cat presentation of the proposal."

Q Now, I know I didn't reread every word in your book any more than I would want to do that now. And her question had to do with whether you explained to Arthur Andersen that you were trying to get the excess profits. Is there any doubt in your mind—

A No, none at all.

Q —that you told that to Arthur Andersen?

(Electronic interference.)

A The whole thing is about the profits. Had there been no excess profit, there would be no tax. Because they didn't raise excess profits, we had tax. It was about those excess profits that we determined, we should have determined, that the whole matter arose. And it was public knowledge everywhere. Of course, in all our verbal briefings, I imagine also in the written briefings we gave to Arthur Andersen, that was the basis for the tax.

Q Do you have in mind the Labor Party's manifesto?

A And indeed the Rhodes manifesto. The precise words were we shall impose a tax on, a windfall tax as we called it, on the excess profit of the private utilities which we shall use to fund youth training programs.

Q Would you explain to the Court what a manifesto is when a party runs for Parliament?

(Away from microphone.)

A When a party runs for Parliament and an election is called it must present its petition with us. It presents a party program for government to be elected. Among the principal commitments they gave in there were the express commitments in terms I'll repeat, Your Honor, that says in addition to the windfall tax on excess profits in privatized utilities, exactly as they put, and in several other documents, in speeches, documents, and the road to the manifesto which is a preparatory document leading up to the manifesto.

MR. GARDNER: I have no further questions, Your Honor.

THE COURT: Is the nature of a manifesto comparable to what we would call a platform?

THE WITNESS: Yes, exactly. I think we may. And it does have the same sort of commitment in it, Your Honor. You have to do it. I mean, I can only repeat if there had not been excess profit, we would not have this tax.

MR. GARDNER: I think the Court understands

Mr. Robinson. I have no further questions, Your Honor.

THE WITNESS: I hope everybody in the Court understands.

(Laughter.)

MR. GARDNER: I have no further questions.

THE COURT: It's not important that everybody understand. Ms. Arndt, do you have any more?

MS. ARNDT: No further questions, Your Honor.

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EXHIBIT 146-R

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judge James S. Halpern

Expert Report Prepared for the
Commissioner of Internal Revenue
by Peter K. Ashton

September 2, 2008

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* * *

Chapter III

Analysis of the Profit-Making Value in the Windfall Tax Formula

In this chapter, I address the two specific questions posed regarding the profit-making value

component in the Windfall Tax formula. Specifically, the questions are:

1. What does the product of the following mathematical formula represent: **Average annualized "book" profit after tax over a 4-year period x price-earnings ratio of 9 = ?**
2. Is the valuation method of capitalizing earnings (e.g., earnings x multiple of earnings) a generally accepted valuation technique for determining the fair market value of a company?

In order to place these questions into the appropriate context, it is meaningful to discuss briefly the basic approaches that are used to value assets and firms.

Overview of Valuation Methods

There are three general approaches to valuation: the income approach, the cost approach and the market approach. Each approach is interrelated and derives from fundamental principles of economics and finance.

Income Approach

The income approach examines a measure of the earnings or cash flows that an entity generates and may be expected to generate in the future and discounts this stream to a known value today. This is often termed a discounted cash flow (DCF) approach. The income approach is frequently used when a forecast of income or cash flows is known and considered reliable.

Cost Approach

The cost approach considers the investment required to replace the utility of the property or asset and uses depreciation or obsolescence factors that are market-related. Where assets are used in combination with one another, i.e., where there is going-concern value and where intangible assets may exist, this approach is not likely to lead to accurate results.

Market Approach

Finally, the market approach examines values related to comparable companies using certain earnings-to-value ratios and also may rely on comparable market transactions to relate value to the assets or firm under scrutiny. Comparable companies operate in the same or similar lines of business as the firm under study. To the extent that similar assets are used by the comparable firms, then this approach will capture the value inherent in these assets.

Two types of data are often used with the market approach. The first relates to the financial and economic performance of comparable firms and how the data may be applied to the firm being valued (often termed the "Guideline Company" or "Market Value Multiples" approach). Multiples that relate earnings to value are often employed where the multiple is derived from a set of comparable companies. This multiple is applied to the earnings (or some other value driver) of the subject company. The second method examines comparable market transactions to provide relevant valuation

information that may be applied to the firm under scrutiny ("Guideline Transactions" approach) This method relates a measure of a property, or an asset's ability to produce income to a market transaction measure to provide an indication of value. As I discuss below, the formula used to compute the profit-making value in the Windfall Tax is a market value multiples approach to determining the value of a firm.

Market Value Multiples Method

The market value multiples method is one of the most extensively used valuation methods and the price/earnings valuation method ("P/E method"—alternatively termed the "earnings capitalization model" or the "earnings multiplier method") is a commonly used method for computing the equity value of a company.[14] The theoretical basis for the P/E method is that there is a fundamental relationship between the stock price of the company and variables such as earnings that drive the value of the stock.[15] This is due in large part to the fact that the share price will incorporate investors' expectations regarding future earnings growth, and thus the P/E ratio is related to the present value of

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[14] Yong Keun Yoo, "The Valuation Accuracy of Equity Valuation Using a Combination of Multiples," *Review* of *Accounting and Finance* 5, p. 2 (2006). Also see Revenue Ruling 59-60 which states "[i]n general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public."

[15] Shannon Pratt et al., *Valuing* a *Business: The Analysis and Appraisal* of *Closely Held Companies,* 5th Ed. (New York: McGraw Hill, 2008), pp. 262-265.

such growth opportunities. Stated somewhat differently, the P/E ratio measures how many times earnings the market is paying for a share of stock in that company.

The formula used to calculate the equity value of a firm using the P/E market multiple approach is as follows:

$$EV_i = E_i \times P_c/E_c$$

Where:

EV_i = equity value of company i

E_i = earnings of company i

P_c = price per share of comparable company[ies] c

E_c = earnings per share of comparable company[ies] c

A common approach to valuation is to estimate a price/earnings ratio for a group of comparable companies, that is, companies that typically operate in the same or a similar industry, and then apply this P/E multiple to the earnings of the company to be valued. Typically some measure of historical (or projections of future) earnings is used; many analysts recommend between 3 and 5 years of historical earnings data. It is also widely accepted that when a market multiple approach such as the P/E method is used, the resulting standard of value is fair market value.[16]

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[16] Ibid., p. 267. Also see for example, Frank Fabozzi and Harry Markowitz, *The Theory and Practice of Investment Management* (Hoboken, NJ: Wiley, 2002), p. 198.

What Does the Profit-Making Value Formula Represent?

It may be seen very easily that the formula that was used in the Windfall Tax computation to determine the profit-making value is identical to the formula shown directly above, i.e., the price/earnings market multiple. Using the notation from the formula above, E_t represents the four-year average of earnings measured as the book profit after tax, and P_c/E_c is estimated to equal 9, which reflects the price/earnings multiple. Thus the profit-making value in the Windfall Tax statutory formula represents a market value multiples method for computing the equity value of a company. The tax, therefore, which is applied at a rate of 23 percent, is applied to a monetary sum which reflects the difference between two *values* of a company, in this case, South Western.

It might be argued that if the P/E ratio of 9 that is used in the profit-making value formula bore little or no resemblance to an actual P/E ratio for electric utilities in Great Britain, then the resulting value might not yield a realistic value for South Western. I have analyzed whether this multiple was a reasonable estimate for regional electric utilities in Great Britain at this time (including South Western), and I find it is a reasonable, although perhaps slightly low, measure. I have analyzed South Western's P/E ratio based on its earnings and share prices from 1993 through 1995. Table 2 shows that the average P/E at year end for these three years was 8.96 which is almost identical to the P/E ratio used in the profit-making value computation.

Table 2 also shows that in 1990 the price/earnings multiple forecasted for South Western using the offer price of £2.40 and projected "pro forma" earnings of £0.284 was 8.09.[17] This is lower than the P/E multiple that was actually used in the Windfall Tax formula, and may indicate the undervaluation of South Western at the time of flotation. Finally, Table 2 also presents the average P/E multiple for the year 1995 for the RECs (including South Western) of 9.52. Thus the P/E multiple of 9 was not outside the realm of reality in terms of generating a fair market value for South Western.

Table 2: Comparison of South Western Electricity P/E at Flotation and During 1993-1995 and REC P/E Value Post-Flotation

South Western Flotation P/E[18] (11/21/90)	8.09
South Western P/E (1993-1995 average)[19]	8.96
Average REC P/E (1995 average)[20]	9.52

[17] This is found in the Kleinwort Benson prospectus (Kleinwort Benson, Ltd., "The Regional Electricity Companies Share Offers," 1990). In fact both the share price and estimated earnings per share for 1991 were higher by early 1992, and the P/E multiple had increased to 8.83. (See Investext Group, "South Western Electricity - Company Report," February 3, 1992). This is also consistent with the multiple used in the profit-making value formula.

[18] Kleinwort Benson Limited, op. cit., p. 274.

[19] South Western Annual reports, 1993-1995.

[20] P/E ratios computed using EPS and price per share data for the RECs from Bloomberg.

Thus in answer to the first question posed to me, the statutory formula used to compute the profit-making value in the Windfall Tax is identical to the market multiples method for computing the value of a firm, or more precisely the equity (stock) value of the firm.

The Market Multiples Approach is a Generally Accepted Method of Computing the Fair Market Value of a Company

The valuation method of capitalizing earnings (that is, where a measure of earnings is multiplied by a price/earnings multiple) is a generally accepted valuation technique for determining the fair market value of a company. It is grounded in the theory that an investor will value a company based on how the market prices or values other comparable firms based on a certain "value driver," such as earnings. As noted this method is often used to determine the equity value of a company. One valuation expert has stated:[21]

> The price-earnings (P/E) valuation method estimates a firm's stock price as the product of its earnings and the P/E multiple determined from a set of comparable companies.
>
> . . . .
>
> The P/E valuation method is used extensively to address valuation questions

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[21] Andrew Alford, "The Effect of the Set of Comparable Firms on the Accuracy of the Price-Earnings Valuation Method," *Journal of Accounting Research* (Spring 1992), pp. 94-95.

> involving initial public offerings (IPOs), employees stock ownership plans (ESOPs), gift, tax, and estate settlements, and corporate restructurings (e.g., mergers and divestitures).

Multiples such as the P/E ratio are frequently used in valuation analyses and are viewed as an accurate means to determine value. One group of analysts states:[22]

> While the multiple approach bypasses explicit projections and present value calculations, it relies on the same principles underlying the more comprehensive approach: value is an increasing function of future payoffs and a decreasing function of risk. Therefore, multiples are used often as a substitute for comprehensive valuations, because they communicate efficiently the essence of those valuations.

Surveys have been conducted as to what methods for valuing firms are most frequently employed. Several have found that the majority of valuation experts prefer the use of a market multiples approach such as using a stock price multiple to earnings measure. Gup[23] states very simply, "The price/earnings ratio is one of the most widely used methods of determining the value of common stock."

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[22] Jing Liu, Doron Nissim, and Jacob Thomas, "Equity Valuation Using Multiples," *Journal of Accounting Research* (March 2002), p. 136.

[23] Benton Gup, *The Basics of Investing* (New York: Wiley & Sons, 1986), p. 321.

Yoo concludes that "a widely practiced technique for the equity valuation of a firm is to use the stock price multiple to an accounting performance measure of the comparable firms (hereinafter simple multiple valuation)."[24] Block reports[25] on a survey which found that over half of the valuation analysts he surveyed use a stock price multiple to earnings (P/E ratio) as the basis for determining the equity value of a firm. Carter and Auken[26] performed a survey of investment analysts which reported that the P/E multiple was the most widely used method for valuing firms and in an earlier study Bing[27] found that a P/E multiple approach was the most common valuation technique among institutional equity appraisers.

Various texts and other treatises on business valuation and investment discuss in detail the use of the market multiple approach to business valuation, including the use of the P/E multiple. Shannon Pratt, one of the leading experts in business valuation, writes:[28]

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[24] Yoo, op. cit., p. 109.

[25] Stanley B. Block, "A Study of Financial Analysts: Practice and Theory," *Financial Analysts Journal* (July/August 1999).

[26] R. Carter and H. Auken, "Securities Analysis and Portfolio Management: A Survey and Analysis," *Journal of Portfolio Management* (Spring 1990).

[27] Ralph A. Bing, "Survey of Practitioners' Stock Evaluation Methods," *Financial Analysts Journal* (May-June 1971).

[28] Shannon Pratt, *The Market Approach to Valuing Businesses* (Hoboken, NJ: Wiley, 2005), p. 4.

A market value multiple is the result of dividing the numerator, which represents dollars of price or value, by a denominator which usually represents dollars of a financial variable of a company. The most familiar market value multiple is the price/earnings (P/E) multiple . . .

In another valuation text, Pratt states:[29]

There is widespread consensus that capitalization of earning power is the most important single factor in the valuation of most operating companies, such as manufacturers, merchandisers, and companies providing various services. Conceptually, capitalization of earning power is a simple, two-variable approach, requiring a figure for a company's earning power and a figure for the appropriate price/earnings ratio.

Another valuation expert, Aswath Damodaran, states:[30]

One of the more intuitive ways to think of the value of any asset is as a multiple of the earnings that asset generates. When buying a stock, it is common to look at the price paid

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[29] Shannon Pratt, *Valuing a Business: The Analysis and Appraisal of Closely-Held Companies* (Homewood, IL: Dow Jones-Irwin, 1981), p. 56.

[30] Aswath Damodaran, *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance* (Hoboken, IL: Wiley & Co., 2006), p. 236.

as a multiple of the earnings per share (EPS) generated by the company.

Finally a British valuation expert writes:[31]

> The price/earnings ratio is the most widely mentioned valuation multiple in the equity markets. It is commonly used by analysts and by investment banks pricing new shares in an initial public offering. When valuing a company for sale using a pie multiple two numbers are required: a figure for earnings; an earnings multiple, normally established by taking the average multiple for similar businesses that are already publicly traded.

Many, if not most, texts and treatises on valuation and investment discuss the use of an earnings multiple approach as a basis for valuing a company or in the case of a stock price/earnings multiple, the equity portion of that firm. Appendix B to this report provides a list of various texts and treatises on valuation and investment which discuss the earnings multiple valuation method.

Thus, in response to the second question, it is clear that the market multiples method is a generally accepted method used by valuation analysts and others to determine the fair market value of a company.

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[31] Andrew Chrisholm, *An Introduction to Capital Markets* (West Sussex, UK: Wiley, 2002), p. 150.

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BEFORE: Judge James S. Halpern

Testimony of Christopher John Wales

October 14, 2008

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* * *

[183]

BY MR. MAY:

Q Dr. Wales, Mr. Lang addressed the presentation that you made to Gordon Brown, and I believe this is Exhibit 116-R if you can get that back in hand. It's the presentation made on November 6 to Gordon Brown.

A Right. Yes.

Q If you'd turn to pages 39 and following. What is the title on the page, page 39?

A It's "Estimating A Windfall"

Q And what follows thereafter on the next three pages?

A This is a series of schedules which are aimed at looking at calculating, estimating the yield that would arise from levying a tax on a series of alternative multiples. It was very much focused on yield, as you will know as policymakers get very much focuses on yield and it was of some interest given a legislative program that Gordon brown had in mind that we needed to fund

Q Each of these calculations starts with realized profits, is that correct?

A Yes.

Q And then you apply a different factor?

A Yes.

Q Factors of six, seven and eight.

A Yes.

Q And the purpose of these is to show yields of different factors?

A That's correct.

Q Is the purpose of this to demonstrate the value at which these companies should have been sold?

A Indeed it's not. It would have been quite difficult to imagine a situation in which you could have offered different valuations on this kind of basis. It would make no sense at all in fact.

* * *

[189]

BY MR. MAY:

Q Dr. Wales, I believe in response to a question by Mr. Lang, you talked about two strands in the rhetoric that are the opposite presentations of this tax. Could you identify those two strands again for us?

A Yes. The two strands are those that I have spoken about before, the main strands, the main justification for the tax, the real reason for the tax was excess profits that were earned by the privatized utilities in the first period of regulation, and when the regulation was considered to be benign—

Q That's the first strand.

A The first strand. And the second strand was the look back to this point, which I've just mentioned that many Labour party members had felt that the utilities had been sold too cheaply. And so, in terms of presentation, it was quite attractive to be able to put both those things together but it produced a tax which raised a significant amount of money relatively easily. It resulted in the legislation that went through the House of Commons in a matter of days, without a great furor and which settled very quickly.

Q Was there a time when Gordon Brown asked you whether he should drop one of those two strands in explaining the tax?

A Someone in Gordon Brown's office asked me about presentation and how we should take it forward, and my advice to him, this must have been

in late 1996, was that it was that he was actually quite attractive to keep both strands of the argument going. Because of the other factors that live described that's what we did. It's how we carried forward. I have to say it worked.

Q At the risk of standing corrected later on, I have one last question. The presentation that you made to Gordon Brown on November 6, did you view that as a presentation of valuation?

A Absolutely not. I mean, if we'd been intending to do a tax that was based on value or the difference between two values, it's inconceivable we would have done a presentation of that sort. There was no attempt in the documents to talk about some method of calculating or recalculating a sensible market value for the companies to base at the date of flotation. There's no substantial work concerning that presentation around the issue of valuation. It's inconceivable that that's how we'd have done it if that's what we were doing.

* * *

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

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v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BEFORE: Judge James S. Halpern

Testimony of Daniel Oösthuizen

October 14, 2008

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* * *

[46]

Whereupon,

DANIEL CHARL STEPHANUS OOSTHUIZEN

having been duly sworn, was called as a witness and was examined and testified as follows:

THE CLERK: Please state your name and business address for the record.

THE WITNESS: I am Daniel, D-A-N-I-E-L, Charl, C-H-A-R-L, Stephanus, S-T-E-P-H-A-N-U-S, Oosthuizen, O-O-S-T-H-U-I-Z-E-N. My business address is Avonbank, Feeder Road, Bristol BS2 OTB.

MR. BIERBOWER: With the Court's permission, you may have a seat.

DIRECT EXAMINATION

BY MR. BIERBOWER:

Q Mr. Oosthuizen, could you please describe your position, where you work right now and your title?

A Yes. I'm the group finance director for Western Power Distribution, which owns four percent of distribution lists.

Q And for which areas are you responsible?

A I'm responsible for finance, tax, treasury, and the secretarial/legal, IT, telecom, and strategy.

Q And does your position roughly correlate with what we would call "chief financial officer"?

A Yes, it does.

Q How long have you held that position?

A I've held that position since 1999.

Q And before that?

A Between '97 and '99, I was assistant to the then-chief executive of W.P.D's works. Between '95 and '97, I was treasurer of SWEB. During 1992 to '95, I was tax manager of SWEB. From 1983 to 1992, I worked at Arthur Andersen in the U.K. in the Tax Department.

Q And what was your position at Andersen when you left?

A Senior tax manager.

Q What were you doing before you joined Arthur Andersen?

A I was working at the University of Bristol doing research and did some teaching as well.

Q Could you briefly describe your educational background for the Court?

A Yes. I hold a B.A. honor's degree from Cambridge University and an M.A. in artificial intelligence and philosophy from University of Sussex, and I'm a qualified chartered accountant and tax adviser.

Q Would you please describe Western Power Distribution?

A Western Power Distribution owns two regulated entities, one of which is D.L. SWEB. What we do, as an electricity distribution company, is we distribute electricity from the national grid to consumers' premises. We don't buy or sell that power; we just deliver it for suppliers from the National grid/

Q And it was formerly known as SWEB.

A We owned two areas. One of them was formerly known as SWEB, yes.

Q And was SWEB one of the privatized companies that became subject to the windfall tax?

A Yes, it was.

Q Would you please describe briefly for the Court how SWEB came to be a subsidiary of PPL?

A SWEB was privatized in 1990, and, for the first review period, from '95, operated as an independent listed company on the London Stock Exchange.

In September '95, the company was purchased, after a hostile takeover bid in which I played some part of the defense, purchased by a company called Southern Electric International, a subsidiary of the Southern Company.

In 1996, they auctioned part of the company to PPL, 25 percent of the company, in 1996.

In 1998, PPL purchased a further 26 percent of the company, giving it a 51-percent overall of the shareholding but not management and control.

Then, in 2001, management and control became shared, although there was no change in the stockholding at that time.

Then, in September 2002, PPL bought the balance of the entity.

* * *

[56]

Q After privatization, were there changes in the method of operation of SWEB and the other RECs?

A Yes, there were. The previous people who had run the boards kept their jobs in functional terms, but the jobs changed. They were no longer working for the government ministers. They were no longer reporting to the treasury. They had stockholders they had to look after and a strategy to develop for their

own organization. So their jobs changed, and they became much better rewarded as a result.

Q So there were changes in compensation.

A Yes, there were. The previous privatization, for example, was indicative rather than a solid manager, but the chief executive of a board would probably be paid something on the order of 50,000 pounds a year and have minimal, if any, bonuses, whereas, after that, they were rewarded more like a listed company's chief executive.

Q Now, when you joined SWEB, what was your understanding of the public perception of the changeover from government entities to private RECs?

A The public's perception at the time was that the directors of the companies were—they were called "fat cats" —the individuals who had been in the right place at the right time and were, if you like, skimming off the cream of the profits that they had been given by an overgenerous, conservative government. That was the public impression.

Q What changes came about, from an accounting standpoint, as result of the privatization of these companies?

A Before the privatization, they were not limited companies, and they were, therefore, not subject to the regulation of companies in the U.K., which is under the Companies Acts. I think there were four of them from 1948 through to 1989.

The Companies Acts specify, apart from normal governance requirements, they specify which

accounting statements have to be prepared, in terms of profit-and-loss balance sheet, and they also require you to comply with generally accepted accounting standards.

So, prior to on privatization, all of those standards suddenly applied to the boards, and they had to become proper companies.

Q So they have had requirements with respect to audit and certification, just like any other private company.

A Yes. Like any other private company, they had to be able to and so on.

Q Would you please describe how the company, and companies like it, was regulated after privatization?

A Before privatization, prices for electricity and other utilities were set by politicians. They decided what the price increase would be and what the financial position of the boards and others would be under the Electricity Council.

At the time of privatization, there was an independent regulator who was to set prices from 1995 onward because the first prices had been set by the government, and, in SWEB's case, it was set at two and a quarter percent plus inflation of what we could increase prices by during that period in each of those five years.

Q How were the prices initially set?

A The prices initially were set by the government to assist the flotation.

Q So they weren't set by Professor Littlechild, those initial prices.

A No, they weren't.

Q All right. What was SWEB's experience with RPI-X regulation?

A Well, with RPI-X regulation, generally, is what you get, given your revenues, so those you know are going to come in. How much money you're going to make depends on how fast and how deep you can cut costs.

So during the first period of privatization, from 1990 to '95, people did cut costs fairly cautiously to keep the system secure. They cut costs and increased profits very rapidly.

Q And was that an intent of RPI-X, as you understood it? A Yes, it was because when you get around to the next price rate of 1995, the regulator can compare companies and can say, "Well, this company has cut so much, and this company hasn't," and reset prices downward to give consumers the benefit of less price from then on going forward. So the intent was, yes, you incentivize to make money for the first in any five-year period so consumers can get the benefit of the offering.

Q Now, Judge Halpern clarified that the first RPI-X price setting was prior to flotation. What was the length of that initial price setting?

A The initial price setting ran through to the 31st of March 1995.

Q What did you do, as an executive, with respect to capital costs and operating expenses?

A I was the taxation manager, so I made charges to other businesses, but I was not directly involved in operations on the ground.

Q What was your impression of how SWEB performed with respect to reducing costs under RPI-X?

A Under RPI-X, I felt that there were always more costs that could be cut, but, at the time, they were certainly making strenuous efforts to cut costs and were trying to reduce head counts and were taking out activities that they didn't think were necessary at the time.

Q Do you recall the RPI-X setting for SWEB in the first period?

A From the period 1990 to 1995?

Q Yes.

A The RIP-X was that it was RPI-plus-2.257.

Q All right. So if inflation was at three percent year, what would be the limit of a price increase?

A If inflation was at three percent, then in each year we would increase our overall revenues by five and a quarter percent.

Q All right. What was the impact, if any, on the company's profits?

A The profits rose significantly during those first five years, as costs were cut. You had a revenue stream that was increasing by more than inflation, and you had costs that you could reduce, and so there was a gap that developed, which was the additional profit that we made in that period.

Q What sort of attrition did you experience among the employees of SWEB during this price set?

A During the first price set, there was some attrition. I think the target was to achieve something like a five or 10 percent cut in staff each year. Whether or not that target was achieved, I'm not clear.

From '95 to 2000, there was significant attrition, in that we lost 20 percent of operational staff towards the end of 1995, and then again, in 2000, we lost half of nonoperational staff and a further 16 or 17 percent of operations staff at the price cut thereafter.

Q What was your understanding of how the other RECs were performing under this regulation?

A I think, in the first period, other RECs were very similar in performance to SWEB. Most companies were cutting some costs, were enjoying healthy revenues, and were increasing profits.

Q Did you observe a reaction among the public with respect to the privatization and the profits that with respect to the privatization and the profits that

A Yes. People felt, in general, that we were far too profitable, and they were very unhappy. I think the term "fat cats" was phrased. Every time the accounts were published, the lead table was published of which chairman had earned the most from his share operations, photographs of his house or whatever.

So the public perception was very poor, both of the executives and of the companies, in terms of people thought that these were companies that had been owned by the people, if you like, and that the

Tory government had sold off the family silver and that this money, the profits we were making, should really have been, at least, in part, returned to them.

Q When you say the "Tory government," you're referring to Margaret Thatcher and the conservative government and their provision program.

A Yes. Margaret Thatcher and John Major and the conservative government, yes.

Q Did this become a political issue?

A Yes. It became a very political issue because whatever the groundswell at the beginning was, the Labor Party stoked it up as much as they could because they were trying to build a picture of the Conservative Party as sleazy and nepotistic and only looking after a small section of society rather than representing the whole country. So they spoke to that significantly.

Q How did you first become aware of the idea of a windfall tax?

A The windfall tax had been floated around in the press loosely almost from the point of privatization. I think it was something that had been around where people used to speculate whether there would be one, if and when the Labor Party ever won reelection.

Q Was the Labor Party attempting to use the privatization and profits issue in the forthcoming election?

A Yes. They—

MR. PRINDIBLE: Objection, Your Honor. It calls for speculation.

THE COURT: I'll sustain it. If you can rephrase to establish that it was within his knowledge.

BY MR. BIERBOWER:

Q As the CFO of SWEB, did you have within your purview, your responsibility, to monitor and observe and pay close attention to political issues as they might affect the corporation?

A Those were the responsibilities of the CFO at the time. I was tax manager at the time that we all received daily the Press Reference Report, which showed how the companies were referred to in the press. So the reports of how that was being used by the Labor Party were common currency.

Q And did you monitor the evolution of this Q And did you monitor the evolution of this

A We monitored it from a distance, if you like, but then towards, I think, the middle to the end of 1996 it became clear, firstly, that the Labor Party would almost certainly win the next election, and also it became part of their policy to have a tax on the profits of the privatized—

Q Do you know why the Labor Party was seeking a windfall tax?

A They had two manifesto commitments that I recall. The first was to have a kind of welfare-to-work program, put people who are long-term unemployed, or the young, back into employment, give them training and opportunities, which would cost money. They also had the commitment not to increase government spending, so there was really a gap between what they were promised and what they

could afford to pay for, and they were going to look to us to fill that gap.

Q Now, as an executive of a privatized company, did you feel that you were the subject of some focus in the political debate?

A Oh, yes. There were several extremely derogatory statements made by senior Labor Party figures at the time. It may not be appropriate to the Court language, but there was a senior Labor Party figure called Frank Dobson, who referred to us as "stupid, incompetent, lying, thieving scum" in headline terms in the paper. That was how they referred to us. It was very, very pretty.

Q How did the company respond to the windfall tax?

A The CO at the time suggested or requested that I put together a package that we could show to somebody who could influence the Labor Party. So what we thought was, if we could avoid the tax altogether, we thought was, if we could avoid the tax altogether, necessarily be successful at that, but if there had to be a tax, at least, we could make sure that it was fairly allocated or, at least, allocated in a way that didn't necessarily give us the greatest burden.

So me and one other employee were set the task of modeling how a tax could work, by drafting what we considered how the legislation would look, and by just monitoring it very closely, hiring lobbyists, and making good contacts that we could with people who were clearly involved with the Labor Party.

Q And what did you do about that?

A What did we do about the—making contacts?

Q Yes.

A I was speaking to somebody about the work that I was doing at Andersen, and he suggested that I talk to Stephen Haley and Chris Wales, which we did. We had a meeting at Sunny Street with Chris Osborne just to go through the package and what we were preparing and some ideas. After some time and some consideration, we also, through the kind auspices of Chris Wales, arranged a meeting with Geoffrey Robinson at Andersen's offices in London.

Q So to clarify, you set out to contact Mr. Haley and Mr. Osborne, who, at the time, were with Andersen.

A Yes.

Q And this would be in their office in London—

A Yes.

Q —on Third Street.

A Yes.

Q All right. Then what did you do?

A We had the meeting with Eccles and Geoffrey Robinson. Chris Wales was there, Chris Osborne, myself, and my chief executive, Gerald Clapper. And at the meeting, we set out our thought, which was that we thought it was a very unfair tax but also that if the tax had to be done, we would prefer it was done transparently and clearly. We showed them our draft legislation, which suggested using consolidated

company accounts, information acquired from company accounts, and they listened to us.

They didn't give us a huge amount of input back, but it was clear from what they said, particularly what Geoffrey Robinson said, that they thought we made too much money and they wanted some of it back.

Q Did you do your own modeling to try and predict and determine what the impact of the tax might be on SWEB?

A Yes, we did. We modeled that on the basis of published accounts of all the privatized utilities, and then we put in the number of how much we wanted to raise at the top and then allocated it according to various formulas in a fairly simple spreadsheet.

Q And those are company accounts?

A Yes.

Q Did you have an idea of how much SWEB would have to pay in the way of windfall tax at the time?

A Our modeling showed that we thought we would have to pay something in the region of 30 to 50 million.

Q Did that prove to be the case?

A No. We ended up paying—the initial assessment was that we would pay around 97 million, which was fairly shocking at the time.

Q How did you find out about this?

A When the finance bill was published, there was a press release published with it, and the press

release contained details of the tax and how it would be calculated. It's not a complicated calculation. So, within a few minutes of reading the press release, you knew just how bad the news was.

Q What was the reaction at SWEB?

A From dismay and shock, we thought it was unfair. We thought it was too much. But, for the most part, there were two things. First, we could challenge it, and I had to explain to my American owners and directors that the sovereignty of Parliament is not to challenge, and there was really no way we could do that.

The second thing we could do was try and minimize what the tax was by seeing if there was anything in the company's accounts that could require a restatement. There is a process in the U.K. where if the accounts don't show a true and fair view, accounts that have already been filed and sent to shareholders, you can restate them and reissue them to all of those shareholders, provided the owners concur.

So we went through a review, tried to identify things where there might be a material effect and had a list of candidates and eventually came down to a provision that should have been made in the 1994-95 accounts to correct remedial tree trimming over the network

Q Now, before I ask you to describe the tree-trimming exercise, why did you look to restate Company Act accounts? What was the focus?

A It was clear from the formula for how the tax is calculated that once you've thought about it for a few seconds, that for every pound you can reduce profits in a year by, you get 51 pounds back because of the reduction in the tax. So it's very easy to work out, that if you can reduce your profits in one year by any amount, you're going to make some of that money back.

Q Explain why you were required to undertake tree trimming on your network.

A The SWEB network has at least 10,000 miles of overhead network. Most of it is on wood poles with metal crossings. The region has a very nice climate. It's very moist, it's very warm, and it's very rural. If you mention the English countryside, it has hedge rows and trees, and it looks very pretty.

The downside to that is that the trees grow, and the trees grow up near the lines, and there is a statutory requirement under 43(a)-15 actually saying that we are obliged to keep tree clearances away from lines where they are harmful and dangerous because people do climb trees and they hit power lines and they get hurt.

What had happened was, over a period of time, we had not trimmed the trees and there were near fatalities, an investigation from the Department of Trade and Industry, which is the government, which was considering a prosecution, and they decided not to do a prosecution on the basis that we then had to maintain those clearances and get those lines cleared of trees so that they would be safe.

Q What was the cost?

A The cost at the time was calculated as being at least 12 million pounds to do the remedial work required.

Q And was that cost amortized, or was it recognized in the year when it was required by the Department?

A In the original accounts that were filed with companies that the companies had, it was thought that they would pay the costs as they arose over the future years, as happened. With the restatement in the accounts, we acknowledged that under Statement of Accounting Practice No.2, that cost should have been recognized in 1994. Because of the obligation, we had created this company by giving the undertaking to the Department of Trade and Industry in May of 1994.

Q And was this conclusion reached by SWEB's auditor?

A Yes, it was. Having identified the issue, we contacted a well-known U.K. firm forensics, Neville Russell, and asked them to review our papers before we went to the auditors to make sure that we were right. We then took it to the auditors of the day, who were Arthur Andersen, but it also had to be concurred with by Ernst & Young, who were the auditors at the time of the original '94-'95 tax filing.

Q What was the date when this was formally acquired of SWEB by the Department?

A By "required of us," to make the provision?

Q Yes.

A In May of 1994 was when we made the commitment to them.

Q And you had a title for the project to fulfill the responsibilities.

A The restatement project, we called "Project Oak."

Q All right. And what did that require, with respect to the company's Company Act accounts?

A It required, first, that we produce a new set of accounts explaining the circumstances of the restatement, which they did.

It also required us to go back into the company's shareholder register from the time when the original accounts were filed, when the company was a publicly traded company with over 100,000 shareholders. We had to find out who we had sent the original accounts to and send each person to whom we had sent a set of the original accounts a set of the new accounts.

Q So the expenses were increased, in effect, on the Company Act accounts for the 1995 fiscal year end.

A Yes, they were.

Q And what effect did that have on the tax liability for the windfall tax?

A It increased the liability by about 12 million, and we got about 6 million back of the windfall tax. So it's the same relationship that I was describing earlier, which is, for every pound you reduce the profits, you get 51 P back. You reduce the profits by

about 12 million, and you've got six million reduced off of the windfall tax liability.

Q I'm not sure if you misspoke. I want to make sure that the record is clear.

You said you increased the liability by 12 million pounds, but you didn't increase the expense.

A Increased the expense in the coming year.

Q All right. Did Inland Revenue accept the position of the company?

A No, they didn't. We were very clear when we filed the windfall tax returns what we were doing and that we had restated the accounts, making full disclosure. We sent a copy of the return both to the windfall tax unit and to our inspector of taxes, Mr. Scott, and they objected. They suggested that we should not have restated the accounts.

We then had some discussions of that, and they have actually referred us to the financial report-and-review panel, which is an organization similar to the FCC whose agreement is to maintain the quality of our financial statement.

MR. BIERBOWER: All right. Your Honor, I don't believe it's necessary to ask Mr. Oosthuizen to go through the documents that he was involved in with respect to this restatement, but I will for the record identify those as Exhibits 55-P through 69-P, and I don't propose to take time to have him to identify those unless that's the wish of the Court.

THE COURT: Well, you've proffered something in the nature of a stipulation. Any objection to that?

MR. PRINDIBLE: No, Your Honor.

THE COURT: Okay.

BY MR. BIERBOWER:

Q So you were principally involved in the restatement process.

A Yes, I was.

MR. BIERBOWER: All right. Now, lastly, I would like to turn to the company's windfall tax return, and if you would take a look at Exhibit 70-J in the binder.

(Pause.)

BY MR. BIERBOWER:

Q Could you please identify Exhibit 70-J?

A Yes. That is our windfall tax return covering that period of the report.

Q Could you be sure to speak into the microphone, please?

When was that return completed and filed?

A The return was filed on the 7th of November 1997. It would have been completed shortly before that.

Q And were you responsible for completing that return?

A Yes, I was.

Q Could you please describe your approach to the completion of that form? What did you do?

A Should I talk through the form or—

Q Let me establish, first, that is your signature that appears on the face of the form, is it not?

A Yes, it is.

Q All right. So would you please describe what you did in filling out the form?

A Other than the first page, where I just—and signed it?

Q Yes.

A If you look at the second page of the return, what the tax is trying to do is tax excess profits, so it's trying to find a way, first, to define what is excess and then to levy the tax on those excess profits.

So if you look at the first block at the top of the page, Section A, the first sets of numbers, it shows you the profits for the first four years after privatization, four years ending the 31st of March 1995, and answers up to a total that comes to 306.2 million pounds.

It then allocates those and works out what the average was, the average annual profits, calculated on a daily basis over that four years, which would be average profits for the four years of 76.497 million. It then multiplies those by a price range ratio of nine to compare it to the flotation value of the company, which is a different number that it applies a percentage of tax to.

Then the formula paid, calculated the liability, excluding the two separate payments, 6 million.

Q Now, focusing on the company restatement here for '94-'95—

A Yes.

Q —does the figure there reflect the company's reduction of expenses by 12 million pounds?

A It's after restatement, yes, after reduced profit.

Q So, on the return that you prepared, you had already performed the restatement and reduced those expenditures for that particular year by 12 million pounds.

A Yes, we had.

Q What impact did that have on the calculation of the windfall tax?

MR. PRINDIBLE: Asked and answered, Your Honor.

THE COURT: Overruled. You may proceed.

BY MR. BIERBOWER:

Q Describe the impact that that reduction in expenditures of 12 million pounds had on the return.

A It reduced our windfall tax liability by about 6 million pounds. If you look at the original calculation that you would have done when you saw the press release, it said we had to pay 97 million pounds. You can see from the return that what we had to pay was 90 and a half million pounds.

Q What's the net effect of that on incremental profits?

A The rate of tax on incremental profits was 51 percent.

Q How would you characterize the tax, based on your experience?

MR. PRINDIBLE: Objection, Your Honor.

THE COURT: On what grounds?

MR. PRINDIBLE: Speculation. It calls for an opinion. He is not an expert; he is a fact witness.

THE COURT: That's fine, but within his capacity as a fact witness, he can speculate to the extent that he is qualified in. He is asking him, in his capacity, with respect to the company, what was his opinion? I'll overrule the objection.

You can answer.

MR. BIERBOWER: Thank you.

THE WITNESS: In effect, the way the tax works is to say that the amount of profits you're allowed in any year before you're subject to tax is equal to one-ninth of the flotation price. After that, profits are deemed excess, and there is a tax. That's how the tax works. It has a definition of what is allowable profit and what is excess profit, and it taxes the excess.

BY MR. BIERBOWER:

Q One last question. In your view, is that view supported by the impact of the company's restatement of its accounts for that particular year?

A Yes, it is.

* * *

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BY MR. BIERBOWER:

Q Mr. Oosthuizen, you were asked by Mr. Prindible whether the calculation that you

performed, upon learning about the windfall tax, was based on the press release. Do you recall that?

A Yes, I do.

Q Had you been performing calculations in anticipation of how the tax was being constructed?

A We had our own ideas about how the tax would be constructed. We had those in the calculations.

Q And you had been studying that with Andersen and others in anticipation of the enactment of the Act.

A Yes. We looked at that internally.

Q When you saw the statutory enactment, is it at that point that you began to work on this restatement of the account?

A Yes, it was.

Q And when you saw the enactment, you knew, for example, that the multiplier of nine times average annual profit, that that multiplier was fixed by statute. Right?

A Yes, it was.

Q And the flotation proceeds; that was also a fixed number that was known.

A Yes. It was a historical fact.

Q So why did you focus in on the Company Act profit as a way to adjust the tax liability?

A It's the only real moving part in the calculation.

Secondly, you can work out very simply what the marginal rate of tax is on profits because it's 23

percent times nine divided by four. When it's divided by four it's because you're averaging four years. The times nine is because the number nine is in there, and the 23 percent is the tax.

So from the calculation, this is what you need to do if you want to change the amount of tax you're paying. You can't change anything that's in the statute; you can only change what's in the accounts, and then you can only change that subject to the rules and regulations of the companies that exist.

Q And to clarify, the requirement to perform the restatement; that was a requirement of the business to do so. Correct?

A Yes.

Q You were mandated to do so by the Department.

THE COURT: What was the last—the requirement to do what?

MR. BIERBOWER: A requirement by the Department to undertake the tree-trimming exercise. Let me restate my question, Your Honor. I may have misspoken.

BY MR. BIERBOWER:

Q The Department required the company to undertake the tree-trimming exercise. Correct?

A Correct.

Q And it was decided to accelerate that 12 million pounds into that year when it was required. Correct?

A Correct.

Q And the auditors agreed with that.

A Yes, they did.

Q And so did the Inland Revenue, ultimately.

A Ultimately, yes, they did.

MR. BIERBOWER: Thank you. No further questions, Your Honor.

MR. PRINDIBLE: Nothing further, Your Honor.

THE COURT: What year was the tree-trimming actually done? I'm curious.

THE WITNESS: It was started in '95-'96, and it ran through four or five years.

THE COURT: And you've accrued the costs in which year?

THE WITNESS: We accrued the costs of the backlog in the fiscal year ending 31 March 1995, but we spent more than the backlog, the accrued amount, over the next four or five years.

THE COURT: So you were actually taking a deduction prior to the actual—I don't think it matters; I'm just curious.

THE WITNESS: We made a provision, put an accrual in.

THE COURT: As a reserve.

THE WITNESS: As a reserve.

THE COURT: Okay. So you reserved it. Okay. And the reason you did that is, looking at the press release with respect to the tax, the only variable, as far as you were concerned, given the number of days since flotation and given the fact that all of the

shares would have been issued, the only variable was the average income for the four-year period. Right?

THE WITNESS: Yes.

THE COURT: And your conclusion was that if I could lower the company's average income for the four-year period, I would save the taxes. So, in other words, any reduction times the tax rate is a savings.

THE WITNESS: That's correct.

THE COURT: The whole point of this exercise, with respect to your testimony, is that you saw the only variable being average profits in lieu of the minimum.

THE WITNESS: Correct.

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UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BEFORE: Judge James S. Halpern

Testimony of Chris Osborne

October 14, 2008

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[105]

Q So, back to my question. The Andersen team also considered enacting a tax that would be an excess-profits tax, expressing that tax as an excess-profits tax. Correct?

A When we used the phrase "excess-profits tax" during the conduct of the assignment, we were contemplating a number of potential versions of an excess-profits tax—or perhaps an actual excess-

profits tax targeted at a particular time period that might be common for some of the utilities. So there were a number of reasons not to go with either of those proposed regulations, but, yes, it was considered.

Q So the Andersen team rejected an excess-profits tax that would be imposed on a specific time period of—

A In particular, we rejected the idea of an excess-profits tax that would work on a prospective basis.

Q And you also rejected an excess-profits tax that would be applied to a specific time period, correct?

A Yes.

Q A typical excess-profits tax.

A Like a—see, many of the excess-profits taxes occur during wartime, and generally they are prospective, and they are made with a view to constraining the profitability of industries that are involved in wartime activities.

Q Were there problems with expressing the tax as a typical excess-profits tax?

MR. MAY: Your Honor, if I may object, there has been no foundation as to what a "typical excess profits tax" is.

THE COURT: But there is testimony in his report as to what the British tax was and what the American tax was during the First and/or Second World Wars and Scandinavian

THE WITNESS: The Scandinavian tax system.

MR. MAY: I'll withdraw the objection.

THE COURT: I'll overrule the objection.

MS. ARNDT: Thank you, Your Honor.

BY MS. ARNDT:

Q One of the problems with expressing this windfall tax as an excess-profits tax was in connection with British gas. Correct?

A No. I'm afraid that's not correct.

Q Are you familiar with Geoffrey Robinson?

A I recall Geoffrey Robinson well, and I recall attention to his book, yes, indeed.

Q So you've read his book on the unconventional minister.

A I've read Chapter 6.

Q You read Chapter 6. Okay. And that's the chapter in which he talks about the windfall tax, correct?

A Yes. The problem with British Gas is that its share price by the time of doing work, it wasn't the case that it had been made excess for terms. The share price was particularly low at the time, but I'm afraid it's not the case that an excess-profits tax in relation to the fuller portions that you have.

MS. ARNDT: I'd like to direct your attention to what's Exhibit 47-R. I believe it's in Binder 4 there behind you.

THE WITNESS: It's actually the book.

MS. ARNDT: The book is up there. I'm sorry.

THE WITNESS: The book itself.

(Pause.)

MS. ARNDT: Please turn to page 72.

(Pause.)

BY MS. ARNDT:

Q I'm looking at the first full paragraph on page 72. Are you there?

A Okay.

Q Okay. This is the paragraph in which Geoffrey Robinson is discussing an excess-profits tax that had been considered and rejected, and Geoffrey Robinson says that, "Over the same period, British Gas profits had decreased by eight percent. Were we to choose excess profits as the basis for the tax and let British Gas off any payment at all, we would have certainly faced legal grounds of discrimination, and the tax would fall at the first hurdle." Do you see that?

A Yes, I do.

Q Okay. And you dispute that.

A No. What he means here is that if we were to choose excess profits, if we were to impose an excess-profits tax on the current level of profits, then British Gas's excess profits would look lower than those of other companies, and there might, indeed, have never been any excess profits if one were to look at the financial period prior to period in which we were doing the exercise.

Q So, basically, British Gas didn't have excess profits that would have been subject to a typical excess-profits tax.

A Well, again, a typical excess-profits tax is forward looking. If one were to have an excess-profits tax which was focused on the financial period just ended, if you like, then British Gas might not have had any excess profits. It's only on a particular version of an excess-profits tax that there would be any kind of an issue at all. Frankly, British Gas's profits decreased by eight percent doesn't actually tell you whether there is any excess in that or not.

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[115]

Q Ms. Arndt asked you about a presentation you made to Gordon Brown in November of 1996.

A Yes.

Q Would you describe the circumstances of that meeting, please: Where was it located? How much time was consumed?

A This was the first time that we met Gordon Brown. We had, by then, done an awful a lot of detailed work on the tax where it would fall, what consequences would there be for the companies at the time that it fell, and whether it could be justly affordable—all of that in meetings with counsel, and we were pretty clear that we had a solution.

So what we were looking for was a formal sign-off, if you like, from Gordon Brown, at the time, and we gave the presentation with a view to arriving, at the end, with a formal sign-off that simply said, "Yes,

I agree. That's the way you should do it." And that was, indeed, the result which—

Q Did Gordon Brown make a lot of inquiries of you during that presentation?

A No. I don't recall that he made any, and it wasn't really configured in that way, and I think probably the manner in which we gave the presentation would have been designed to suppress any inclination that anybody might have felt to ask questions because we were looking for a clean sign-off. We didn't want to go off on a tangent and discuss why we didn't want to do it on a revenue basis when it was quite clear to us that that was not what we wanted to do.

Q That presentation does include a description of other ways to go about constructing the tax. Is that correct?

A That is correct, yes.

Q Can you explain the context of that?

A Again, the context was that we did not wish a situation to arise in which Gordon Brown might say, "Yes, but I would like to talk about doing it on this different basis."

So we wanted to kill off, as it were, any idea of pursuing those different bases early on so that we could then focus on the basis that we had arrived at, which we thought was very good, actually, and that was what we were doing. That's what we were doing.

Q His Honor asked you some questions about the character of the tax and took you to your report and its concluding paragraph, and I think you were

careful to say that you were not rendering a legal opinion as to an excess-profits tax.

A Yes.

Q Mr. Osborne, what was the object of this tax?

A Again, "object," now that's a funny word, isn't it? It could mean all sorts of things to different people. The purpose of the tax was to identify a level of excess profits and to tax it.

Q Did you at any point think you were constructing a tax on value?

A It was very convenient to express the tax in the language of value of a capital gain, but there was no time during the exercise when we believed that we were identifying a value in its formal sense, that these companies should, could, would, or might have actually been sold for.

What we were doing was putting a construct together by which to compare the profits that were made in the initial period after privatization with the privatization proceeds, and that's what you have to do in order to identify whether those profits are excessive, and we chose to do it backwards for presentation reasons, the reasons for a presentation.

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BY MR. MAY:

Q Ms. Arndt asked about presentational issues, and the term "presentational" does appear in here in your report. Are you familiar with the term "optics"

when one is talking about a presentation or something?

A Yes. We've started to use it in the U.K.

Q So it's migrated from our language to yours, has it?

A I believe so.

Q And was one of the optics for this that the Labor Party could, to its own members and others, complain about the privatization of the utilities? A That is my understanding.

Q And that rhetoric took its form as "sold too cheaply.

A That is my understanding.

Q So do the optics of the tax you designed address that point?

A It allowed Geoffrey Robinson and Gordon Brown, in presenting the tax, to appear to be responsive to the concerns of the members of that party, who had said that these companies were sold too cheaply.

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UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BEFORE: Judge James S. Halpern

Testimony of Edward L. Maydew

October 15, 2008

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[347]

BY MR. BIERBOWER:

Q Dr. Maydew, you were asked questions about the incidents of the windfall tax on profits, you recall that?

A Yes.

Q And I'll represent to you that the parties have stipulated in this case, stipulation 146, that no

windfall tax company had a windfall tax liability that exceeded its total profits over its initial period. Does that change your opinion or assist your opinion in any way?

A That was my understanding to begin with, yes. The tax never exceeded the total profits.

Q And you were asked about whether your analysis was directed as net income, and you were asked questions about the financial reports. Can you explain for the Court please how income is defined differently, the difference between net income in the financial reports and the income tax filings.

A That would take quite a while to do in detail, but—

Q Well is there a distinction between the two that matters with respect to your conclusion?

A No because in the sense that accounting income is based on realization and net revenue is minus expenses in the accrual concept, so at that level there's a similarity. There's definitely a difference when you get down to the level of how do you recognize depreciation expense and things like that.

Q And it's your opinion that the windfall tax falls predominately on income tax, is that correct?

A It definitely falls on accounting income.

Q All right, now there was some discussion about your examples on page 9 as well as the windfall tax return that swept right?

A Yes.

Q And Mr. Prindible observed that the taxable amount exceeded the cumulative income of one of your example companies.

A The taxable amount, yes. Not the tax.

Q In your report on page 9 when you discuss those examples, do you also go on to show that the effective marginal tax rate on income is 51.75 percent?

A Yes I do. That's the general result.

Q And do you also show with an algebraic equivalence analysis that this effective tax rate applies to income at the rate of minus 11.1 percent of IPO value?

A That's the tax rate on the income in excess of an 11 percent rate of return on the floatation value which is the key characteristic of an excess profits tax.

Q Now you were also asked about your analysis when you first did the mathematical or algebraic equivalence analysis when you looked at the FSA?

A Yes.

Q Could you explain how you formed that calculus? What led you to form that algebraic analysis and how did you do it?

A Well, I was curious because the tax was expressed in a strange way that I had not seen before so what I was trying to do was to make sense of it, to try to put it to see how it operated. So I came up with a numerical example with probably roughly similar numbers as we have here to determine what it was

ultimately taxing. And that helped me make sense of what kind of tax this was.

MR. BIERBOWER: All right. No further questions, Your Honor. Thank you.

MR. PRINDIBLE: We have just a few more.

MR. BIERBOWER: Your Honor, before he goes, I have one last question.

THE COURT: Go ahead.

BY MR. BIERBOWER:

Q You were also asked questions about whether the statute is literally based on differences between two values and you agreed that the statute is worded in a way that speaks of two values right?

A Yes it is worded that way.

Q When you answered, did you have in mind or mean a normal or accepted financial value?

A I think, well the way the statute is worded, it's, for the profit making value it's hard to interpret that as anything other than just a number. So when I say value it's really just value as a number, it's not market value or fair market value. The floatation value could be considered a measure of value I think, which is actually similar to prior excess profits taxes which were based on the invested capital approach.

Q But the value in profit making terms in your opinion is a mathematical value and not an actual financial value.

A It's a mathematical value. It would be accidental if it was an actual fair market value.

MR. BIERBOWER: Thank you. No further questions, Your Honor.

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UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BEFORE: Judge James S. Halpern

Testimony of Philip W. Baker

October 15, 2008

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[434]

THE COURT: But if I understand the Petitioner's, the taxpayer's point of view as manifest by their expert testimony, particularly the testimony of Professor Myers, their argument is that it is not the difference between two values, value being used not as the value of a figure in a calculation but value used in terms of value in terms of worth. Their argument is it's not the difference between value at

time 1 calculated one way and value at time 1 calculated a different way.

It's the difference between an amount, they would use I think the term amount for the first amount, the value in profit making terms, they would say that's an amount based on income. It's not in substance a fair market value. They would concede that the second amount, the value for privatization purposes is indeed a market value and they would attack your testimony on the grounds that it isn't helpful because you've assumed that the first amount is a worth, a market value.

And what my questions are directed at is trying to understand whether you have simply accepted the notion that the first amount is a market value. And in terms have looked solely at the form of the statute as opposed to looking at its substance in terms of saying, well let me see how this formula works and but for the description of it as a value on the privatization day, I can't see how it's a value on the privatization day as opposed to a value at any time during the period or the value at the end of the period or indeed how independent of its description of a value it's a valuation in fair market terms at all.

THE WITNESS: I'm giving different testimony obviously from Professor Myers and others because they're opposed—

THE COURT: Oh of course, you're on the other side.

THE WITNESS: I'm a lawyer and I think I remember Professor Myers saying you can't get to the, probably roughly say, you can't get the answer by looking at the legislation. I'm here to explain the U.K.

legislation and the U.K. legislation clearly talks in terms of comparing two values. And I'm certainly not here saying this is a market valuation at any point in time because I'm not an expert in market valuations.

I'm saying that the U.K. legislation uses the terms of comparing two values and it then tells you how to calculate those two values, and from my reading, it's two values at exactly the same time. Whether the value in profit making terms of the disposal made in the occasion of a company's flotation is exactly how Professor Myers would have valued it at date of disposal or how any other value at that date, from my point of view, it's not relevant. This is how the U.K. Parliament phrased the tax base in terms of two values different ways of calculating the value.

I can say that so far as the value in profit making sense is concerned, they do take a method which I can certainly recognize as a way of getting to the value of shares, i.e. you take an income and multiply it by a price to earnings ratio, and 9 is always described as the price to earnings ratio, whether that gives you the same value as an expert in valuation, like Professor Myers would have given you, or not is irrelevant.

The U.K. Parliament I think fixed this formula because they didn't want to have disputes about how you value the shares at that time. They put into the formula an exact way of valuing using known, by the time the legislation came into force, known information so that it was possible to determine without any dispute what those two values were.

THE COURT: Yes. I think from a calculation point of view, I haven't heard anything about a dispute as to how the values are figured. But it strikes me that accepting it for the moment as a definition of value the first part, the probability that it accurately reflects the value of the privatized company on the privatization day is no greater than the probability that it accurately reflects the value of the privatized company on the 1997 date right?

THE WITNESS: Well—

THE COURT: And it's no greater than the probability that it accurately reflects the value of the privatized company on any date at any point in time ever.

THE WITNESS: That's probably right actually there that it's a statutory formula to identify a value it's probably—at the date of privatization, no one would have known what the profits were going to be at a later time. At the date of the legislation corning into force, you get a sense it's a historic value because it's looking back at any event at periods prior to April 1997.

THE COURT: I agree completely, but I'm asking you, and I don't know that you know the answer, but if the probability is no greater that it is accurately predicting the value in April of 1997 than it was accurately predicting the value at the—

THE WITNESS: That's right.

THE COURT: Well if it were assumed to be predicting the value in April of 1997 and you subtracted from it the value of the company on the

privatization day, you basically get the increase in the value over the term, which might be akin to a calculation of the amount of income earned by the company over that period of time.

In other words, if you take the value of a company, this calculation of earnings undistributed just to make it a very simple cartoon case, over the next three years, and putting inflation aside, I could take the value of the company on its balance sheet at the end of those three years, subtract from it the value of the company at times zero, and what I would have is a measure of the income earned by the company over three years.

THE WITNESS: I suppose it would also depend on where you get your figure of value from.

THE COURT: The initial figure.

THE WITNESS: But if you took your figure of value from the profits over that period—

THE COURT: Well, I'm saying I look at book. I'm actually doing it from book. I start with book at times zero and I peg that as value at times zero. And then I look at the balance sheet at the end of three years, the balance sheet reflecting book, and it's higher. So the company has made profits over three years. If I subtract the former from the latter, I have a measure of the profits over three years.

THE WITNESS: I suppose you've got to ignore things like dividends and things.

THE COURT: Yes. Well, I don't have to, but I can make it more complicated. I could make it, you know,

retained earnings. I don't know the terminology. But I could put in the figure dividends easily.

THE WITNESS: I think what you're saying actually is that if you start at zero and then you simply accumulate profits and then at the end of three years, the company has zero plus accumulated profits, then you take that as the value at the end of the period and the other as the value at the beginning of the period, you are taxing those profits. The way you defined it, I suppose the answer must be yes because that's the only factor that you've taken into account.

THE COURT: But not all relates to the schedule, the statute, unless you can say that the value for privatization shouldn't be the value for profit making terms is the value at times zero, as opposed to the value of the NAPO in 1997, then you really can't say whether this is taxing value or taxing income.

THE WITNESS: Well, the legislation requires you to do two value calculations. Currently, one of those value calculations, a factor is an outreach profit.

THE COURT: No, I understand, if you're taking the statute and reading the value and profit making terms as accurate to the time of privatization and being a calculation of value at the time of privatization, you can say that my analysis, which analyzes it to a measure of income, is just wrong, because it isn't the value at the end of that term.

But what I'm driving at is putting the form aside and looking to the substance of what's being calculated under the rubric of value for profit making purposes, independent of the statute, can you say in

any other context that that would be a fair measure of the value of the company at privatization?

THE WITNESS: I don't think an expecting valuation would say it was fair measure of the value. But you keep on saying independent of the statute; and I come back to say, I'm here as a lawyer to say it's a deterrent to the statute to tell you what the definition of the tax base is. Parliament defined it in terms of the difference between two values, and it explained what those two terms were.

THE COURT: Okay, I think I understand exactly what you're saying. I think I understand what my questions were. So I'm now going to give counsel an opportunity to ask any further questions.

* * *

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THE COURT: There's been testimony that in the definition of the—well, I'm at Schedule 1, Quantification of Privatization Windfall Debased Rule, paragraph 2, "Those amounts are the following," etcetera. "The value in profitmaking terms of the disposal made on the occasion of the company's flotation."

There's been testimony that the term "value in profitmaking terms" is unknown outside of this statute and is therefore a word of art. My question is, with respect to your understanding of how judges in the U.K. would attempt to interpret this term, apparently I take it you can't look at it and say what it means other than taking the words individually and looking them up in the dictionary. So, if there

were some question as to what it means, what would be the resources that the Judge could bring to bear?

THE WITNESS: Well, first of all, may I confirm that I don't know that the term has been used anywhere else other than in this context.

THE COURT: That's what I understand. That's what the testimony has been.

THE WITNESS: Yes. That's right, yes. And I agree with that.

THE COURT: So we can be agreed on that.

THE WITNESS: Absolutely. And the answer would be that the judge would look at the particular wording here, and of course that is a term of art and so it is explained subsequently as to how you compute the value in profitmaking terms. And I personally don't find anything unclear or lacking In clarity in the definition that's set out in paragraph 2.

So it's unlikely that a judge would have any need to go outside the wording of the statute. If the judge did feel that there was some lack of clarity, then quite limited resources. You can look at anything in the Queen's printer's version, so you can look at the heading and of course you look at the legislation in its entirety, so how it fits in.

THE COURT: What we would refer to as in context.

THE WITNESS: Absolutely. You would look at a dictionary. If there was a lack of clarity or an absurdity, you could look at a statement made by the minister in Parliament when introducing this legislation. You could apply certain presumptions of statutory interpretation such as Parliament does not

intend to legislate extraterritorially. That's not really, applicable here. By and large, it is very much a textual analysis, looking at the wording of the legislation.

* * *

PETITIONER'S BRIEF

No. 12-43

In the
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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December 13, 2012

QUESTION PRESENTED

To avoid double taxation, section 901 of the Internal Revenue Code allows U.S. corporations a tax credit for income, war profits, or excess profits taxes paid to another country. Since at least 1938, when this Court first addressed the issue, courts have looked beyond a foreign tax's form and labels and considered its practical operation and intended effect when determining whether it is creditable for U.S. tax purposes. This case involves the application of section 901 to a "windfall tax" imposed by the United Kingdom. Although it is undisputed that the tax's practical effect is to impose a 51.75% tax on the "excess profits" certain companies earned in the four years after they were privatized, the Third Circuit—at the Commissioner's urging—reversed the Tax Court's considered judgment and, departing from decades of precedent, deemed the tax non-creditable merely because the U.K. statute nominally taxes the difference between two numbers, one of which is driven exclusively by profitability during the four-year period, rather than nominally taxing the profits themselves.

The question presented is:

Whether, in determining the creditability of a foreign tax, courts should employ a formalistic approach that looks solely at the form of the foreign tax statute and ignores how the tax actually operates, or should employ a substance-based approach that considers factors such as the practical operation and intended effect of the foreign tax.

RULE 29.6 STATEMENT

PPL Corporation is a publicly traded Pennsylvania corporation. No publicly held company owns 10% or more of PPL Corporation's stock.

The following subsidiaries of PPL Corporation have an interest in this litigation: (1) PPL Energy Funding Corporation, which is wholly owned by PPL Corporation; (2) PPL Global, LLC, which is wholly owned by PPL Energy Funding Corporation; (3) PMDC International Holdings, Inc., which is wholly owned by PPL Global, LLC; and (4) PPL UK Holdings, LLC, which is wholly owned by PMDC International Holdings, Inc.

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JURISDICTION

The Court of Appeals rendered its decision on December 22, 2011, and denied a petition for rehearing on March 9, 2012. On May 10, 2012, Justice Alito extended the time for filing a petition to and including July 9, 2012. The petition was timely filed and granted on October 29, 2012. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of section 901 of the Internal Revenue Code, 26 U.S.C. § 901, and Treasury Regulation § 1.901-2 are reproduced in the appendix to this brief. App. 1a–49a.

STATEMENT OF THE CASE

This case involves the creditability for U.S. tax purposes of a "windfall tax" imposed by the United Kingdom on a group of companies that were privatized during the 1980s and 1990s. It is undisputed that the U.K. statute's practical effect was to impose a 51.75% tax on the "excess profits" the companies earned in the four years after they were privatized. For reasons involving the British political dynamic at the time and having nothing to do with the substance of the tax, however, the U.K. government structured it as a tax on the difference between two numbers or "values"—one of which was driven

exclusively by actual income earned during the four-year tax period—rather than as an express tax on income. The question before this Court is whether the creditability of the windfall tax under section 901 should turn, as the Commissioner has argued, on the labels and form the U.K. government chose to employ or, as the regulation, the case law, and common sense instruct, on the practical operation of the windfall tax.

A. Statutory and Regulatory Background

When Congress enacted the federal income tax in 1913, it chose to tax all income earned by U.S. citizens and corporations, including income earned and taxed abroad. *See* Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114. Although Congress allowed U.S. taxpayers to deduct taxes imposed by foreign countries from their income, it initially did not give taxpayers a credit for those taxes—even income taxes—against their U.S. tax liability. As a result, the U.S. tax scheme created a significant potential for double taxation of income earned abroad. When combined with "taxes levied in the United States," "the corresponding high rates imposed by certain foreign countries ... place[d] a very severe burden upon" U.S. citizens and corporations earning income abroad. H.R. Rep. No. 65-767, at 11 (1918). To alleviate that burden, Congress enacted the foreign tax credit, which provides U.S. citizens and corporations a credit for "the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein." Revenue Act of 1918, Pub. L. No. 65-254, §§ 222, 238, 40 Stat. 1057, 1073, 1080.

The "primary design" of the foreign tax credit "was to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932). The provision focused on income and profits taxes because those taxes raised the prospect of double taxation, in that the same income or profits would be taxed twice—once by the foreign government and once by the United States. Other foreign taxes, such as real estate taxes, continued to be subject only to a deduction, which roughly paralleled the treatment of those taxes domestically. The credit also was intended "to produce uniformity of tax burdens among U.S. Taxpayers, irrespective of whether they engaged in business abroad or in the United States," *Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256, 283–84 (1995), and served the important purpose of "facilitat[ing] the[] foreign enterprises" of domestic corporations. *Chicago Portrait*, 285 U.S. at 9. In addition, as Congress recognized, double taxation of income earned abroad "places American business concerns at a serious disadvantage in the competitive struggle for foreign trade." H.R. Rep. No. 67-350, at 8 (1921). By eliminating that disadvantage, the foreign tax credit helped grow the U.S. tax base and economy as a whole. In the century since its enactment, the credit has become a critical feature of the U.S. income tax system: Domestic corporations claim tens of billions of dollars in foreign tax credits each year. *See* Scott Luttrell, IRS SOI Bulletin, *Corporate Foreign Tax Credit 2007*, Summer 2011, 140 fig.B, (foreign tax credits claimed from 2003 to 2007 ranged between $50 billion and $86 billion a year).

Although Congress has amended the foreign tax credit statute from time to time, the provision setting

forth which taxes are creditable—"income, war profits, and excess profits taxes"—has remained unchanged since its enactment in 1918 and is now found at section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1). The guiding principle underlying interpretation of the statute also has remained unchanged: Since this Court first considered the issue nearly 75 years ago, it has been settled law that the meaning of terms employed in the foreign tax credit statute is to be derived from "our own revenue laws," not from the revenue laws of foreign countries. *Biddle v. Comm'r*, 302 U.S. 573, 579 (1938). Whether a foreign tax is an "income," "war profits," or "excess profits" tax thus depends on the substance of U.S. tax law, not on the labels or form chosen by the country that imposes the tax.

Consistent with this Court's direction, federal courts have looked beyond the form of foreign taxes to their substance, even treating, for example, a foreign tax nominally on gross receipts—not net income or profits—as creditable when its practical operation was as a tax on net income. *See Bank of America Nat'l Trust & Sav. Ass'n v. United States* ("*Bank of America I*"), 459 F.2d 513, 520–21 (Ct. Cl. 1972) (discussing cases). In 1983, the Treasury Department promulgated a regulation addressing whether a foreign tax is an income, war profits, or excess profits tax. *See* Treas. Reg. § 1.901-2. The preamble to the regulation explains that the "predominant character" standard the regulation sets forth is meant to adopt the same substance-based approach to creditability employed in *Bank of America I* and other pre-regulation cases. 48 Fed. Reg. 46,272, 46,273 (Oct. 12, 1983).

Under the regulation, which uses the term "income tax" to refer to all three types of taxes, a tax is creditable if "[t]he predominant character of that tax is that of an income tax in the U.S. sense." § 1.901-2(a)(1)(ii). To meet that "predominant character" standard, a tax must be "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). That is the case "if and only if the tax, judged on the basis of its predominant character, satisfies" three tests: It must be imposed (1) on realized income (*i.e.*, income that has already been earned), (2) on the basis of gross receipts (*i.e.*, revenue), and (3) on net income (*i.e.*, gross receipts minus significant costs and expenditures). § 1.901-2(b)(1)–(4). Those three tests track the traditional definition of a U.S. income tax. *See, e.g.*, *Eisner v. Macomber*, 252 U.S. 189, 207–08 (1920). In short, to be creditable, the "predominant character" of a foreign tax must be such that it typically reaches realized gross receipts less deductible expenses—that is, net gain.

B. The U.K. Windfall Tax

The story of the U.K. windfall tax begins in 1979 when the Conservative Party won control of Parliament. During the nearly two decades of Conservative Party rule that followed, the government brought substantial new foreign investment into the United Kingdom by privatizing dozens of nationalized companies, including many regulated utilities. JA256. To accomplish its objectives, the government typically would transfer a nationalized company to a new public limited company and offer shares of the new company to the public at a fixed price per share. In U.K.

parlance, that initial share offering is known as "flotation." After flotation, the company's shares would become publicly traded on the London Stock Exchange at whatever value the market set.

Between 1984 and 1996, the U.K. government privatized more than 50 companies. JA23–24, 30. The government initially privatized primarily non-monopoly companies, but later expanded the privatization program to include state-run monopolies such as utilities. JA206, 258–59. With that expansion came the need to establish a regulatory scheme to oversee the newly privatized companies. Rather than dictate their maximum profits or rates of return, the government decided to regulate their prices. By fixing prices for an initial period, typically four years, the government hoped to incentivize the companies to reduce costs and increase efficiencies, thereby maximizing profits that initially would pass exclusively to the companies and their new shareholders. JA223, 263–64. The regulatory scheme created the potential for the companies to enjoy substantial profits during the initial period. (JA854) Once that period ended, however, the government would pass the benefits of lower prices and increased efficiencies on to consumers through a downward price adjustment.

The newly privatized companies embraced this regulatory scheme, and their shareholders quickly began reaping the rewards of significantly reduced costs and increased efficiencies. But the public grew concerned that the companies were making too much in profits, and the Labour Party, seizing on this political opportunity, began demanding the very price

adjustments the government had promised to forgo until the end of each initial price control period. The government resisted the pressure but ultimately paid a price: In 1997, the Labour Party defeated the Conservative Party at the polls.

Although the Labour Party had opposed privatization from the start, by the time it returned to power, re-nationalization was no longer a realistic option. JA274. Nonetheless, the party continued to contend that privatization had unduly benefitted many of the new companies, and it campaigned on a vow to impose "a windfall levy on the excess profits of the privatised utilities." Pet.App.31. The party promised to use the revenue from that tax to fund a £5 billion welfare-to-work youth employment training program. Pet.App.31.

In 1996, as a Labour Party victory became increasingly likely, members of the party's shadow treasury, including future Paymaster General Geoffrey Robinson and future Chancellor of the Exchequer Gordon Brown, retained Arthur Andersen to determine how best to structure the promised tax. Although a number of companies had been privatized, the goal was to tax only those companies (primarily utilities) subject to the price control regulatory scheme that produced high profits in the years immediately after privatization. The Labour Party made clear from the outset that the Andersen team was to "design a windfall tax on the excess profits of the privatised utilities." JA326. In response, the team devised a one-time "windfall tax" to be imposed on what the Labour Party viewed as excess profits achieved during the immediate post-privatization

period. JA334–35. The tax applied only to companies "whose privatisation involved the imposition of economic regulation." Finance (No. 2) Act, 1997, c. 58, part I, cl. 1 & 2(5) (U.K.); App.50a–72a.

As embodied in the act Parliament passed, the windfall tax employs a simple concept but a considerably more complicated formula. The simple concept is that the new government used the companies' actual realized profits (*i.e.*, gross receipts less expenses) during the first four years after privatization to impose a tax reflecting the new government's view that the companies had reaped windfall profits during that initial period. The more profitable the company was during those four years, the higher the tax. That was true not just in some vague sense that the tax and those profits were positively correlated—windfall tax liability increased in direct proportion to the profits realized by the company.

The more complicated formula was based on the difference between two numbers: a company's value based on the highest fixed price at which its shares were offered when it was privatized (*i.e.*, its actual flotation value) and the company's "value in profit-making terms," which the statute defined by reference to a company's actual, realized past profits and an arbitrary fixed "price-to-earnings ratio." As set forth in the statute, the formula operates as follows:

Total realized profits ("P") during the tax period are used to determine average annual profits, which are multiplied by a statutorily fixed "applicable price-to-earnings ratio" of 9. Flotation value ("FV") is then subtracted, and the remainder is taxed at 23%. Using

"D" to represent how many days a company operated during the tax period, the statutory formula can be stated as:

$$Tax = 23\% \times \left(\left[\frac{365}{D} \times 9 \times P \right] - FV \right)$$

Because most companies subject to the windfall tax operated for 1,461 days, or four years (with one leap day), during the relevant period, tax liability typically amounted to approximately:

$$Tax = 23\% \times \left(\left[\frac{1}{4} \times 9 \times P \right] - FV \right)$$

or

$$Tax = 23\% \times \left(\left[\frac{9}{4} \times P \right] - FV \right)$$

Stated in those terms, the windfall tax nominally taxes the difference between two numbers or "values"—the actual flotation price, and a figure based on profits earned during the first four years after privatization. But while flotation value is an actual historical number, "value in profit-making
an artificial construct that do
real-world value of t
value based on the p
on a date certain). JA.
is a *sui generis* term
actual profits during th
that was coined solely
Pet.App.60–61 n.17; *see*
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substance was a tax on excess profits during the four-year period, specifically, a 51.75% tax on total period profits in excess of 4/9 of flotation value. *See* Pet.App.63–64.[1]

To illustrate, if the figures inside the parentheses are multiplied by 4/9 and the figure outside the parentheses is multiplied by 9/4, the formula becomes:

$$Tax = \left(\frac{9}{4} \times 23\%\right) \times \left(P - \left[\frac{4}{9} \times FV\right]\right)$$

Doing the math, that produces:

$$Tax = 51.75\% \times \left(P - \left[\frac{4}{9} \times FV\right]\right)$$

By these simple mathematical calculations, the same tax thus can be formulated as either a 51.75% tax on profits in excess of a statutorily prescribed rate of return, or a 23% tax on the difference between two numbers ("flotation value" and "value in profit-making terms"). Under either formulation, a company's tax liability increases or decreases in direct proportion to its total profits in excess of 4/9 of flotation value during its initial period. That exact mathematical equivalency demonstrates unequivocally that the practical operation of the windfall tax is as a tax on excess profits. In one form, the tax looks like a tax on

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[1] The Tax Court described the tax as a 51.71% tax on profits in excess of 44.47% of flotation value. Pet.App.63. That slight variation reflects the inclusion of the extra leap year day, which makes the ratio used to determine average annual profits slightly more than 4/9 (*i.e.*, 44.4%). For simplicity, this brief uses the figure 51.75% throughout.

the difference between two numbers. In the other form, the tax looks just like past U.S. excess profits taxes and past U.K. excess profits taxes that have been held creditable. And both forms yield precisely the same amount of tax liability.

C. The Proceedings Below

South Western Electricity plc ("SWEB") was one of 12 regional electric companies privatized in 1990. JA241. It was also one of 32 regulated companies that were more profitable than anticipated and thus became subject to the windfall tax. Pet.App.43–44. SWEB's total windfall tax liability as assessed by U.K. Inland Revenue was £90,419,265 (*i.e.*, SWEB had earned about £175 million more than the Labour government thought appropriate and was taxed 51.75% of that amount). JA43. SWEB paid the tax in two installments, the first in 1997 and the second in 1998. JA45. At the time, SWEB was a partially owned indirect subsidiary of PPL Corporation ("PPL"). Accordingly, for its 1997 federal income taxes, PPL claimed a credit under section 901 for its share of SWEB's first windfall tax payment. The Commissioner disallowed the claim, and PPL petitioned the Tax Court for review.

1. The Arguments and Evidence

The essential dispute between the Commissioner and PPL in the Tax Court boiled down to a single dispositive legal question: whether, in determining creditability, courts should use a substance-based approach that takes into account the practical and intended operation of the foreign tax, or must instead

use a formalistic approach that confines the analysis solely to the labels used by the foreign tax statute.

Consistent with the Treasury Regulation and the decades of case law it adopts, PPL argued that creditability "depends on the substance, and not the form or label, of the tax." Pet.App.57–58. Under that approach, this is an easy case. The predominant character of the windfall tax is "that of an income tax in the U.S. sense" because the tax by both effect and intent "is likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(1)(ii), (3)(i). Indeed, the windfall tax is not just "likely to reach net gain"—it is guaranteed to reach a specific percentage of net gain that exceeds a threshold deemed by the Labour government to represent the cut-off between acceptable and excess profits. In other words, it is guaranteed to reach 51.75% of profits in excess of 4/9 of flotation value.

To prove as much, PPL provided extensive testimony from expert witnesses, including specialists in both U.S. and U.K. tax and accounting, Pet.App.59; JA353–445; an internationally acclaimed finance professor, Pet.App.59–60; JA446–91; members of the Arthur Andersen team who designed the windfall tax, Pet.App.32–33, 58–59; JA247–93; and the U.K. regulator who devised the relevant regulatory scheme and regulated 17 of the 32 companies subject to the tax (including SWEB), Pet.App.27–29, 58; JA196–247. Those witnesses all agreed that, in substance, the windfall tax operates as a tax on income, and in fact operates just like past U.S. and U.K. excess profits taxes. Pet.App.57–60. PPL's experts illustrated how the tax formula can be restated as a 51.75% tax on

profits in excess of 4/9 of flotation value, a mathematical reality to which the Commissioner stipulated. Pet.App.62 & n.20; JA427–30, 457–61. And to illustrate beyond peradventure the exclusively profits-driven practical operation of the tax, SWEB's former treasurer explained how, once he realized the direct link between tax liability and profits under the windfall statute, he obtained permission from the U.K. Financial Reporting Review Panel (over the initial objection of Inland Revenue) to restate SWEB's profits for one of the tax years and, as a result, was able to reduce SWEB's windfall tax liability in direct proportion (51.75%) to that reduction in profits. Pet.App.61; *see also* JA42–43, 190–92, 550–51, 556–58.

The Andersen witnesses testified that the drafters of the tax understood that it operated as an excess profits tax but dressed it up as a tax on the difference between two purported "values" for "presentational" reasons peculiar to the U.K. political and economic environment at the time. Pet.App.58–59. They explained that they were "instructed" by the Labour Party "to design a windfall tax on the excess profits of privatised utilities," JA333, and that "[f]rom the start, there was never any doubt that" they were tasked with designing an "excess profits" tax, JA326. The Andersen team further testified that an excess profits tax "is what we all believed the 'Windfall Tax' to be." JA329; *see also, e.g.*, JA292.

Finally, the evidence at trial confirmed the U.K. government's understanding and intent that the windfall tax would operate as a tax on excess profits. When Chancellor Brown introduced the tax as part of

the 1997 budget, he explained that "[o]ur reform of the welfare state ... is funded by a new and one off windfall tax on the excess profits of the privatised utilities." JA126. Later that same day, Inland Revenue released a notice stating that "[t]he Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities." JA128, 241, 275. Throughout the enactment process, the government repeatedly described the tax as "meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities." JA146; *see also, e.g.*, JA140 (U.K. Treasury publication describing statute as imposing a "windfall tax ... in accordance with the commitment in the Government's Election Manifesto to raise a tax on the excess profits of the privatised utilities").

Rather than dispute PPL's evidence in any material respect, the Commissioner argued that the Tax Court should ignore it altogether. In the Commissioner's view, the court was bound by the U.K. statutory formulation of the windfall tax as a tax on the difference between two "values," even though the higher of those two figures was an artificial number derived exclusively from actual realized profits over a four-year period. Pet.App.65–68. Under the Commissioner's formalistic approach, because the statute says it taxes the difference between two "values," not excess profits, the tax is not creditable. As the Commissioner put it, in an argument that would seem to deny the form-substance dichotomy altogether: "The words of the U.K. statute *are* the 'substance' of this tax." Reply Br. for Resp. 11, *PPL Corp. v. Comm'r*, No. 25393-07 (U.S. Tax Ct. 2009).

The Commissioner alternatively argued that the tax was intended to tax the difference between two values and uses realized profits merely as "a reasonable approximation of how ... [c]ompanies might have been valued at the time of flotation if subsequent earnings could have been known." Pet.App.70.

2. The Tax Court's Decision

After reviewing all the expert reports and trial testimony in both this case and a parallel case involving the same U.K. windfall tax, the Tax Court issued a 62-page opinion holding the windfall tax creditable. Pet.App.22–86; *see also Entergy Corp. v. Comm'r*, 100 T.C.M. (CCH) 202 (2010) (summarily finding same tax creditable based on its *PPL* decision).

Like the parties, the Tax Court considered dispositive the legal question of what a court "may consider in determining whether the windfall tax is a creditable tax for purposes of section 901." Pet.App.71. The court rejected the Commissioner's formalistic answer to that question as contrary to the foreign tax credit statute and "inconsistent with the 1983 regulations' description of the predominant character standard for creditability." Pet.App.72. Examining the regulation's instruction to consider whether "the foreign tax is likely to reach net gain *in the normal circumstances in which it applies*," § 1.901-2(a)(3)(i) (emphasis added), the court concluded that, by "implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations clearly signaled their intent that factors extrinsic to the text of the foreign tax statute play a role in the determination of the tax's character." Pet.App.72–73.

The Tax Court found that conclusion "consistent with caselaw preceding the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the 'criterion for creditability' embodied in that standard." Pet.App.73 (citing *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982), and *Bank of America I*). It further noted that "cases that have applied the ... regulations' predominant character standard are consistent" with that approach, and rejected the Commissioner's attempts to portray those cases as limiting courts to considering only the form of a foreign tax statute. Pet.App.75–76.

Reviewing the windfall tax's practical effect, the circumstances of its adoption, the understanding of the Andersen team that designed it, and the public statements of the Labour ministers who presented it, the Tax Court agreed with PPL that the windfall tax operated in substance as a tax on excess profits. Pet.App.23–45. The court explained that PPL's restatement of the tax as a 51.75% tax on excess profits was not, as the Commissioner argued, a "hypothetical rewrite of the Windfall Tax statute," but rather "a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax." Pet.App.83. Considering that and all of PPL's other evidence to the same effect, the Tax Court concluded that "the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits." Pet.App.78–79.

3. The Third Circuit's Decision

The Commissioner appealed the *PPL* decision, and the Third Circuit reversed. Pet.App.16–19. The

Commissioner once again stressed that "the court should consider only the language of the windfall-tax statute" and not "the actual effect of the tax on the windfall companies." Opening Br. for Appellant 11, *PPL Corp. v. Comm'r*, No. 11-1069 (3d Cir. 2011). In an opinion that became bogged down in mathematical formulas and a portion of the regulation that the parties stipulated was not applicable, JA193–94, the court concluded that the tax was not creditable.

Although the court purported to examine the "substance" of the windfall tax, it in fact applied a wholly formalistic approach: It refused to consider PPL's arguments about the practical or intended operation of the tax and instead resolved creditability based solely on the form of the U.K. statute. As for PPL's argument that the tax operates as a 51.75% tax on excess profits, the court deemed that "formulation of the substance of the U.K. windfall tax ... a bridge too far" based on its view that "[t]he regulation forbids" consideration of any formulation that "rewrite[s] the tax rate." Pet.App.9, 14. Accordingly, the court examined whether the windfall tax satisfies the regulation's gross receipts and realization tests based on the assumption that the tax must be formulated as follows:

$$Tax = 23\% \times [2.25 \times P]$$

Of course, 23% multiplied by 2.25 is 51.75%, and so this formulation of the tax should have made clear that the tax equaled 51.75% of the excess profit. Nonetheless, because it inexplicably deemed such multiplication "a bridge too far," the Court ignored this mathematical equivalence and simplistically concluded that "2.25 times profit" is greater than

profit alone and, therefore, that the tax is not imposed on the basis of gross receipts or on realized income. Pet.App.9, 12, 14–15 & n.3.

In reaching its conclusion, the court relied heavily on a single illustrative example from a section of the regulation that addresses how to determine whether a tax that is *not* based on *actual realized* gross receipts, but instead is based on an estimation of expected gross receipts, satisfies the gross receipts test. *See* Pet.App.13–14; Treas. Reg. § 1.901-2(b)(3)(ii), ex. 3. Although both parties explained at oral argument that this Example 3 does not apply here—the profit figure used to calculate the windfall tax is derived from *actual* gross receipts (and otherwise satisfies the regulatory tests for net profits)—the court decided that Example 3 rendered irrelevant the mathematical certainty that a 23% tax on 2.25 times profit is identical to a 51.75% tax on profit.

The Third Circuit's decision directly conflicts with the Fifth Circuit's decision in the companion *Entergy* case, which the Commissioner also appealed. After reviewing the Tax Court's analysis in *PPL* and the Third Circuit's decision rejecting it, the Fifth Circuit agreed with the Tax Court and held the windfall tax creditable. *See Entergy Corp. & Affiliated Subsidiaries v. Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012). Finding the Commissioner's formalistic argument "easy to dispatch" in light of the regulation and the case law it adopts, the court viewed the tax "in practical terms" and concluded that it readily satisfies the gross receipts, realization, and net profits tests. *Id.* In doing so, the Fifth Circuit emphasized that the U.K. government's decision to label an

"entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax." *Id.* at 236–37. The court rejected the Third Circuit's contrary conclusion as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Id.* at 237.

SUMMARY OF ARGUMENT

The Commissioner's core contention in this case is a remarkable one. In his view, the standard for determining the creditability of a foreign tax is so rigidly formalistic that a court must ignore the *undisputed* fact that the practical operation of a foreign tax is as a tax on profits, and instead confine its analysis *solely* to the labels and form used in the foreign tax statute. In other words, even though foreign taxes are imposed in numerous foreign languages, by countries with radically different tax systems, and for reasons unique to those countries, the Commissioner would have the labels and form a foreign country employs, and not the substance of the tax it imposes, determine how the tax should be treated for purposes of U.S. tax law.

That approach is so contrary to common sense—not to mention the substance-over-form principle that pervades U.S. tax law—that it could prevail only if the foreign tax credit statute unambiguously compelled it. As this Court concluded nearly 75 years ago, section 901 does no such thing. Instead, this Court and lower courts have consistently recognized that the context of evaluating the U.S. tax consequences of foreign taxes enacted in a variety of different languages and systems all but demands a consideration of substance,

not form. And the Commissioner's own regulations expressly embrace a substance-over-form approach that looks to the practical operation of a foreign tax and whether it is "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). In short, as the Fifth Circuit correctly concluded, the Commissioner's core contention is easy to dispatch: The creditability of a foreign tax turns on its substance, not the labels or form a foreign country employs.

Once the Commissioner's hyper-formalistic approach is rejected, this is an easy case. There is no real dispute that the U.K. windfall tax is, in substance, an excess profits tax in the U.S. sense. The tax is the mathematical equivalent of a 51.75% tax on excess profits. Indeed, SWEB conclusively proved as much when it restated its profits and reduced its windfall tax liability by 51.75 pence for each pound that it reduced its reported profit. Both the drafters of the tax and the Parliament members who adopted it acknowledged that it was designed as and operated as a tax on excess profits. And those profits were unambiguously net profits in the U.S. sense, *i.e.*, actual realized gross receipts less costs and expenses over a four-year period. The tax thus was not just "likely," but *certain*, "to reach net gain in the normal circumstances in which it applies." Because that is all the statute, the regulation, and the case law require to establish creditability, the windfall tax is creditable, and the decision below should be reversed.

ARGUMENT

The Commissioner's hyper-formalistic position in this case is born of necessity. Unless labels and form

are all that matters, this is a remarkably straightforward case. The Commissioner concedes that the windfall tax operates just like a 51.75% tax on excess profits earned during the four years immediately following privatization, *i.e.*, the portion of net profits in excess of the threshold the U.K. government decided was appropriate for the companies it taxed. And the Commissioner concedes that those excess profits are net profits in the U.S. sense, *i.e.*, they are the companies' actual realized gross receipts less costs and expenses during the four-year period. Indeed, the Commissioner could hardly contend otherwise, as the windfall tax's equivalence to a 51.75% tax on excess profits is a matter of mathematical certainty, and SWEB reduced its windfall tax by 51.75% of the reduction in its reported profits when it restated its income for one year of the relevant tax period. In short, the Commissioner essentially concedes that the windfall tax is, in substance, an excess profits tax in the U.S. sense.

Given those undisputed facts, the Commissioner has no choice but to insist that courts may not consider the substance of a foreign tax *at all* when determining creditability, and instead must confine their analysis to the labels and form that a foreign country chose to adopt. In his view, simply because the windfall tax is nominally a tax on the difference between two numbers or "values," and not formally labeled a tax on excess profits, it is not creditable. Never mind that one of those two numbers is an artificial number derived from actual, realized net profits during a four-year period, thus plainly rendering a tax on the difference between the two a tax on those reported profits. According to the

Commissioner, because the U.K. government did not *call* the windfall tax an excess profits tax, the Court must turn a blind eye to the fact that it is one.

Only under a statute that compelled the most formalistic of approaches to creditability could that argument prevail. Indeed, given that substance trumps form in every other U.S. tax law context, it would take particularly compelling evidence to conclude that Congress intended form to trump substance in this most unlikely of contexts. But as this Court and lower courts have recognized for decades, section 901 gives no indication whatsoever that Congress intended to adopt the Commissioner's illogical approach to creditability. In fact, as the case law repeatedly makes clear, the statute compels exactly the opposite—namely, that the creditability analysis *must* evaluate substance, not form.

That case law is directly applicable because it served as the foundation for the regulation, which explicitly adopts the approach of the cases that came before it. Like those cases, the regulation instructs courts to ignore labels even to the point of treating foreign taxes nominally on gross receipts as income taxes so long as their practical operation makes them likely to reach net profit. *A fortiori*, the U.K. windfall tax, which *necessarily* reaches net profit, is creditable under that substance-based approach. In short, far from supporting the Commissioner's rigid approach to creditability, the statute, the regulation, and the case law it incorporates all adopt the common-sense approach that substance, not form, must govern when considering the U.S. tax consequences of taxes imposed by foreign governments.

I. Whether A Foreign Tax Is Creditable Depends On Its Substance, Not The Labels Or Form A Foreign Country Employs.

Under any sensible approach to determining the U.S. tax consequences of a tax imposed by a foreign country, whether a tax is creditable must turn on its substance, not the labels that the enacting country employs. Indeed, it is difficult to imagine a context less suited to a rigidly formalistic approach than determining the treatment for U.S. purposes of foreign taxes, which may not be written in the same language, often reflect different tax systems, and usually arise under unique legal, political, and social regimes. Recognizing as much, every court to consider the issue—including this one—has rejected the notion that the creditability analysis should elevate form over substance, even in cases in which the taxation of profits as a substantive matter was far less obvious than here. So, too, did the Commissioner when he put in place a regulation that adopts the same substance-based approach that the case law before it established. In short, nothing in the foreign tax credit statute, the regulation, or the governing case law provides any support for the hyper-formalistic approach on which the Commissioner's position depends.

A. The Principle that Substance Trumps Form Is a Fixture of U.S. Tax Law Generally and Foreign Tax Credit Cases in Particular.

1. Because any rational tax scheme demands uniform application, "tax law deals in economic realities, not legal abstractions." *Comm'r v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956). The

familiar "principle of looking through form to substance" thus is "the cornerstone of sound taxation" and is pervasive throughout tax law. *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961). The courts and the Commissioner alike have routinely invoked that principle when determining the tax consequences of a transaction. *See, e.g.*, *Boulware v. United States*, 552 U.S. 421, 429 (2008) ("tax classifications ... turn on the objective economic realities of a transaction rather than ... the particular form the parties employed"); *Comm'r v. Hansen*, 360 U.S. 446, 461 (1959) ("the incidence of taxation depends upon the substance, not the form, of the transaction"); Br. for the United States, *United States v. Consumer Life Ins. Co.*, Nos. 75-1221, 75-1260, 75-1285, 1976 WL 181554, at *34 (U.S. 1976) (emphasizing "the familiar axiom that economic substance rather than form is controlling for purposes of federal taxation"); Joseph Isenbergh, *Review: Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859 (1982) (describing how the Commissioner has consistently and successfully relied on substance versus form distinction in litigation).

That well-settled principle is regularly applied in a host of contexts when determining the legal consequences of a tax. For instance, when examining whether a state tax is preempted by federal law, this Court has reiterated that "neither state courts nor Legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect." *Macallen Co. v. Massachusetts*, 279 U.S. 620, 625 (1929); *see also, e.g.*, *Jefferson Cnty., Ala. v. Acker*, 527 U.S. 423, 539 (1999)

("[t]he practical impact, not the State's name tag, determines" whether a tax violates federal law).

The same rule has been invoked when evaluating the constitutionality of taxes in multiple contexts, including the Privileges and Immunities Clause, *see, e.g.*, *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287, 297 (1998) (analysis "must depend not upon any mere question of form, construction, or definition, but upon the practical operation and effect of the tax"); the dormant Commerce Clause, *see, e.g.*, *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 183 (1995) (considering "not the formal language of the tax statute but rather its practical effect"); the Due Process Clause, *see, e.g.*, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940); and the intergovernmental tax immunity doctrine, *see, e.g.*, *City of Detroit v. Murray Corp. of America*, 355 U.S. 489, 492 (1958). As this Court has stressed, courts must look past "the formal language of the tax statute [to] its practical effect." *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

The logic behind the principle that substance, not form, must govern is obvious: Any other approach would wreak havoc on the stability and uniform application of tax law. "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945). Accordingly, whether dealing with the tax consequences of a transaction or the legal consequences of a tax, it is well settled that a "given result at the end of a straight path is not made a

different result ... by following a devious path." *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

2. If there were one context in which abandoning the rule that substance trumps form would make the least sense, it would be in determining the domestic tax consequences of a tax imposed by a foreign government. Indeed, the concept of confining the analysis to the words or form of a statute makes no sense when it comes to taxes that may be assessed in myriad languages, by countries with fundamentally different tax systems, and for political, economic, and social reasons unique to those countries. There is no reason to expect those foreign countries to adopt the sometimes obscure locutions of our Internal Revenue Code. The process of translating—literally and figuratively—foreign taxes for purposes of U.S. tax law demands an inquiry into their practical operation and effect.

A purely formalistic approach to determining the creditability of foreign taxes would also undermine the important policy purposes Congress intended the foreign tax credit statute to serve. One of the credit's central aims is to promote uniform treatment of U.S. taxpayers. Another is to "facilitate," rather than discourage, "the[] foreign enterprises" of domestic corporations by assuring them that they will not face double taxation at home on profit that has already been taxed by the country in which it was earned. *Chicago Portrait*, 285 U.S. at 9. Those purposes can only be achieved by a rule that looks beyond the form of countless foreign taxes to determine whether in practical operation they subject income to double

taxation. If the analysis were to turn on form, not substance, a tax with the exact same practical effect of imposing double taxation could be creditable when imposed by one country but not when imposed by another. Moreover, foreign governments often have just as many political and legal incentives as our own legislatures to manipulate the "form, construction, or definition" of a tax to obscure its "practical operation and effect." *Lunding*, 522 U.S. at 297. Congress could hardly have intended to elevate those foreign efforts above substance when the unifying principle throughout our own tax law is that substance trumps form.

In keeping with those common-sense principles, this Court long ago rejected the illogical notion that the creditability of a foreign tax should "depend upon its characterization by the foreign statutes and by decisions under them." *Biddle*, 302 U.S. at 578. *Biddle* involved the meaning of the phrase "income taxes paid" in the foreign tax credit statute as applied to British tax laws governing stockholders and corporations.[2] Under the relevant British law, stockholders were "required to report as income, in addition to the amount of dividends actually received, amounts which reflect their respective proportions of the tax paid by the corporation on its own profits." *Id.* at 575. In other words, British law "treat[ed] the

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[2] At the time, the foreign tax credit statute was codified at 26 U.S.C. § 131. While it has since been recodified, the statute allows a credit now, as it did in 1938, for "the amount of any *income ... taxes paid*" to a foreign country. 26 U.S.C. § 901(b)(1) (emphasis added).

stockholder as though he were the taxpayer" even though the tax was in fact paid by the corporation. *Id.* at 581. Because U.S. law would treat the corporation, not the stockholder, as having paid the tax in that situation, the question arose whether the stockholder could receive a credit under the foreign tax credit statute.

In answering that question in the negative, the Court explained that "[t]he phrase 'income taxes paid,' as used in our own revenue laws, has for most practical purposes a well-understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes." *Id.* at 579. "It is *that* meaning," the Court concluded, that "must be attributed" to the term in the foreign tax credit statute. *Id.* (emphasis added). Even though British law treated the stockholder as having "paid" the tax, the dispositive question remained whether "what the stockholder has done in conformity to British law ... is the substantial equivalent of payment of the tax as those terms are used in our own statute." *Id.* Any other approach would produce "a shifting standard" for creditability based on the vagaries of "foreign characterizations and classifications of tax legislation" by countries that may not use the same language, let alone the same tax system, as the United States. *Id.* As the Court concluded, nothing in the foreign tax credit statute remotely suggests Congress intended such a counterintuitive result. *See id.* at 578–79. Substance thus trumped form in *Biddle* in a way that benefitted the U.S. Treasury to the detriment of the taxpayer. Ever since, courts have focused on the substance and practical effect of foreign taxes without regard to

whether that approach favors the government or the taxpayer.

3. Following *Biddle*'s instruction to "examin[e] ... the *manner* in which [a] tax is laid and collected," *id.* at 579 (emphasis added), courts have determined creditability by focusing on the substance, not the form, of foreign taxes. For instance, the Court of Claims confirmed in *Bank of America I* that the "important thing" is the substance, not the form, of a foreign tax. 459 F.2d at 519. *Bank of America I* involved three foreign taxes that on their face did not satisfy "the United States notion of income taxes" because they were imposed on gross receipts, with no comparable deduction for costs or expenses to ensure that only net gain was taxed. *Id.* at 517. In keeping with *Biddle*, however, the Court of Claims refused to "consider it alldecisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit." *Id.* at 519. Recognizing that there are situations in which the "costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of gross income," thereby ensuring that "the assessment would fall ultimately upon" the "net gain remaining," the court concluded that "a levy can in reality be directed at net gain even though it is imposed squarely on gross income." *Id.* As the court put it, "[t]he important thing is whether the other country is attempting *to reach* some net gain, not the form in which it shapes the income tax or the name it gives." *Id.* (emphasis added).

Seatrain Lines, Inc. v. Commissioner, 46 B.T.A. 1076 (1942), one of the cases on which *Bank of America I* relied, is illustrative of the substance-based approach that courts have employed when applying section 901. *Seatrain* involved a 3% tax on gross income Cuba had imposed to replace a predecessor 6% tax on net profits. *See Bank of America I*, 459 F.2d at 520. While the Cuban government imposed the new tax on gross income, not net gain, the tax was nonetheless held creditable because the halving of the tax rate approximated the amount of the foregone deductions and thus ensured that the 3% gross income tax had the same practical effect as the 6% tax on net profits that it replaced. *Id.* Because "the key is *the effect* of the foreign tax on net gain," the Court of Claims explained, "a gross income tax which embodies within itself (via the rate or otherwise) consideration of the taxpayer's relevant costs and expenses" is every bit as creditable as a tax on net income at a higher rate. *Id.* at 520–21 (emphasis added).

The Tax Court employed the same substance-over-form approach in *Bank of America National Trust & Sav. Ass'n v. Comm'r* ("*Bank of America II*"), 61 T.C. 752 (1974), agreeing with the Court of Claims that "the 'basic' test for determining whether a foreign tax is creditable is whether it is the substantial equivalent of an 'income tax' as revealed by an examination of our statutes." *Id.* at 760. And the Court of Claims reaffirmed that approach in *Inland Steel*, where it reiterated that "[t]he label and form of the foreign tax is not determinative" of creditability, which instead turns on "whether taxation of net gain is the ultimate objective or effect of that tax." 677 F.2d at 80.

The creditability questions in those cases were substantially more difficult than in the case at hand, where the foreign tax undisputedly falls on net profits, *i.e.*, gross receipts minus expenses and deductions. Nonetheless, those lower court cases are relevant for two reasons. First, as noted, the Commissioner's effort to treat a tax on the difference between two numbers or purported "values," one of which is derived exclusively from profits, as something other than a tax on excess profits depends on a hyper-formalistic application of section 901. Thus, the substantial body of lower court precedent following *Biddle* and looking to substance over form—even to the point of treating a tax on gross receipts as a tax on net income—greatly undermines the Commissioner's position.

Second, and equally important, these cases form the foundation on which the Treasury Department based its regulation in 1983. By that time, it was already settled law that the creditability of a foreign tax under section 901 does not turn on questions of form. As the cases recognize, when confronted with a foreign tax that does not nominally fall on income in the U.S. sense, the statute requires courts to examine the practical operation of a tax to determine whether, notwithstanding its label and form, the tax was likely to reach net gain in the U.S. sense. Far from attempting to abandon that settled interpretation of the statute as compelling a substance-based approach to creditability, the Commissioner's 1983 regulation expressly embraces it.

B. The Treasury Regulation Embraces the Same Substance-Based Approach to Creditability as the Cases Before It.

1. Not only does the language of Treasury Regulation § 1.901-2 mirror almost precisely the standard the case law articulates, but the preamble to the final regulation confirms that it "adopts the criterion for creditability set forth in *Inland Steel* ..., *Bank of America* [*I*] ..., and *Bank of America* [*II*]." 48 Fed. Reg. at 46,273; *compare* § 1.901-2(a)(3)(1) ("The predominant character of a foreign tax is that of an income tax in the U.S. sense [i]f ... the foreign tax is likely to reach net gain in the normal circumstances in which it applies."), *with Bank of America I*, 459 F.2d at 519–20 (tax is an income tax if "it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies"), *and Inland Steel*, 677 F.2d at 80 ("To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which the tax applies."). Thus, under the regulation, as under the cases before it, creditability turns on the "ultimate objective or effect" of a tax, not "[t]he label and form" the foreign country gives it. *Inland Steel*, 677 F.2d at 80.

The regulation itself refutes any contrary contention. Section 1.901-2 reiterates more than a dozen times that creditability turns not on the labels or form of a foreign law, but on the "predominant character" of the tax it imposes. *See, e.g.*, § 1.901-2(a)(1)(ii), (a)(3), (b)(1), (b)(2)(i), (b)(3)(i), (b)(4)(i). That term comes from the Commissioner's own substance-

based determinations in pre-regulation creditability decisions. *See, e.g.*, Rev. Rul. 56-51, 1956-1 C.B. 320 (tax's "predominant character will determine whether the tax is an income tax"). The regulation further instructs that courts must assess the "predominant character" of a foreign tax by determining whether the tax is "likely to reach net gain *in the normal circumstances in which it applies.*" § 1.901-2(a)(3)(i) (emphasis added). As the Tax Court explained, that language does not just invite consideration of the practical effect of a foreign tax; it demands it. *See* Pet.App.72–73 ("By implicating the circumstances of application in the determination of the predominant character of a foreign tax," § 1.901-2 confirms "that factors extrinsic to the text of the foreign tax statute play a role in the determination of the tax's character.").

Other provisions throughout the regulation also instruct that the practical operation of a foreign tax can render it "an income tax in the U.S. sense," § 1.901-2(a)(1)(ii), even if the foreign country did not label or structure it as such. For example, the regulation treats a tax as satisfying the net income test not only if it allows for "recovery of significant costs and expenses," but also if it "provides allowances that *effectively compensate* for nonrecovery of such significant costs or expenses." § 1.901-2(b)(4)(i) (emphasis added). And the regulation goes on to explain that even a gross income tax that does neither can still satisfy the net income test if, "in the normal circumstances in which it applies," a taxpayer's "costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid

persons subject to the tax are almost certain to have net gain." § 1.901-2(b)(4)(i)(B); *see also, e.g.*, §§ 1.901-2(a)(2), (d)(1), (f)(3) (requiring application of U.S. principles when considering effect of a foreign tax).

Like the case law that preceded it, the regulation thus allows some foreign taxes to be treated as creditable income taxes for U.S. purposes even if they are denominated gross receipts taxes. In that respect, it is far more permissive than anything remotely necessary to treat a tax nominally on excess "value" as a tax on excess profits when such "value" is derived exclusively from actual net profits over a four-year period. And those permissive provisions are also completely inconsistent with a hyper-formalistic insistence that the language and form of a foreign statute should dictate the outcome. It is impossible to determine whether "businesses subject to [a] tax are almost certain never to incur a loss (after payment of the tax)," *id.*, without looking beyond form to examine how a tax actually affects those who pay it. Other provisions of the regulation similarly demand consideration of the practical operation of foreign taxes. *See, e.g.*, § 1.901-2(b)(3)(i)(B) (describing circumstances in which a tax imposed on the basis of an *estimation* of gross receipts may nonetheless be treated as imposed on the basis of gross receipts).

At bottom, the very existence of the regulation thus belies the Commissioner's position, as the whole point of the regulation, like the cases before it, is to illustrate how to determine whether a foreign tax that is *not* labeled or structured like "an income tax in the U.S. sense," § 1.901-2(a)(1)(ii), should nonetheless be considered one. The *raison d'être* of the regulation is

fundamentally inconsistent with the Commissioner's position here. If the language of the foreign statute were all-decisive, the regulation would not exist in anything like its current form.

2. In keeping with the understanding that § 1.901-2 embraces the substance-based approach the cases before it applied, courts have continued to eschew a formalistic approach to creditability since the regulation took force—often at the Commissioner's express urging. Indeed, if anything, courts have suggested that § 1.901-2 places even greater emphasis than the case law that preceded it on the practical operation of a foreign tax. That is particularly evident in the Second Circuit's decision in *Texasgulf, Inc. & Subsidiaries v. Commissioner*, 172 F.3d 209 (1999), which involved the same tax the Court of Claims had concluded was not creditable in *Inland Steel*. The Court of Claims had reached that conclusion after determining that the costs and expenses not deductible from gross income under the tax were "too widespread and important to permit the conclusion that some net gain is sure to be reached." *Inland Steel*, 677 F.2d at 85. But in *Texasgulf*, the taxpayer produced quantitative evidence that one of the tax's other allowable deductions operated in such a manner that, for the majority of taxpayers, it exceeded the amount of nondeductible expenses U.S. law would have allowed. *See Texasgulf*, 172 F.3d at 213.

In deeming that evidence sufficient to affirm the Tax Court's holding that the tax was creditable, the Second Circuit explained that § 1.901-2 contemplates consideration not only of the kind of "qualitative analytic evidence" the Court of Claims had considered

insufficient in *Inland Steel*, but also of "quantitative, empirical evidence" of how a foreign tax actually affected the taxpayers who were subject to it, *id.* at 216—*i.e.*, the exact kind of evidence PPL presented to prove conclusively that the windfall tax operates as an excess profits tax. *Cf.* U.S. Tax Ct. R. 146 (permitting consideration of "any relevant material or source" when "determining foreign law"); 2 Joseph Isenbergh, *International Taxation* ¶ 56.2.4, 56,005–06 (4th ed. 2011) (explaining that regulation "enlarge[d] the range of applications of the *Bank of America* doctrine that are favorable to taxpayers").

Texasgulf presented a much more difficult creditability question than the case at hand. But the point is that any appreciation of the flexible, practical, experiential approach reflected in the regulation and employed in the cases that preceded and followed it makes clear that, as the Fifth Circuit correctly concluded, the Commissioner's "primacy of the ... text" argument is "easy to dispatch." *Entergy*, 683 F.3d at 236. As every court save the Third Circuit has recognized, both the regulation and "[t]he case law from which [it] is derived refute[] the Commissioner's assertion that [courts] should rely exclusively, or even chiefly, on the text of' a foreign tax statute when determining creditability. *Id.* "The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." *Bank of America I*, 459 F.2d at 519. Accordingly, the creditability of the U.K. windfall tax depends on whether "the predominant character of th[e] tax is that of an income tax in the U.S. sense," § 1.901-2(a)(1)(ii), not on whether the U.K. government chose to label or present it as such.

II. The Predominant Character Of The U.K. Windfall Tax Is That Of An Income Tax In The U.S. Sense.

The Commissioner's insistence on a rigidly formalistic approach to creditability in this case is understandable. Applying the substance-based standard that the statute, regulation, and case law compel, there can be no serious dispute that the U.K. windfall tax is creditable. As the Commissioner conceded, the tax operates exactly like a 51.75% tax on excess profits in the normal circumstances in which it applies. Pet.App.62 & n.20; JA 35–41. It is not just likely, but a certainty, that the tax reaches net gain because although it is nominally a tax on the difference between two numbers or "values," one was derived exclusively from actual, realized net profits in the four-year period following privatization. Under a correct application of the long-established test for creditability, any contention that the tax is not creditable must fail.

A. The Windfall Tax Is Not Only Likely But Certain to Reach Net Gain in the Normal Circumstances in Which It Applies.

1. Under the regulation, the creditability of a foreign tax turns on whether, "judged on the basis of its predominant character," the tax "is likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(b)(1). The U.K. windfall tax easily satisfies that standard. As the Commissioner stipulated in the Tax Court, *see* Pet.App.62 & n.20; JA 35–41, it is not just "likely," but a mathematical certainty that, for the vast majority of taxpayers, the

windfall tax reached 51.75% of profits in excess of 4/9 of flotation value. *See supra* p.10.[3] Indeed, SWEB conclusively proved as much when it made a downward adjustment to its reported profits and reduced its windfall tax liability by 51.75% of the amount of the reduced profits. Pet.App.61. There is also no dispute that the actual, realized profits in the years following privatization that were used in the windfall tax calculation were "net gain" in the U.S. sense—*i.e.*, they were measured by subtracting significant costs and expenses from gross receipts. *See* Tr. of Oral Argument 39–40, *PPL Corp. v. Comm'r*, No. 11-1069 (3d Cir. 2011). In fact, the Commissioner "stipulated that none of the 31 companies that paid windfall tax had a windfall tax liability in excess of its total profits over its initial period." Pet.App.79. Accordingly, for every company that paid it, the windfall tax was not just "likely to" but did *in fact* "reach net gain." § 1.901-2(b)(1).

As the Fifth Circuit correctly concluded, "[v]iewed in practical terms," the windfall tax thus is plainly creditable. *Entergy*, 683 F.3d at 236. The tax "is

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[3] That was the case for 27 of the 32 companies subject to the tax. Of the remaining five, one paid no windfall tax because it had no excess profits. Pet.App.64–65. For three more, the effective tax rate and percentage above which profits were considered excessive differed marginally because their initial periods were slightly longer or shorter than four years. Pet.App.64. The final company had a significantly shorter initial period (only 316 days), and thus was treated as an outlier by the Tax Court. Pet.App.65; *see Exxon Corp. v. Comm'r*, 113 T.C. 352 (1999) (tax need only "satisfy the predominant character test in its application to a substantial number of taxpayers").

based on revenues from the ordinary operation of the utilities that accrued long before the design and implementation of the tax," and thus "clearly satisfies the realization and net income requirements." *Id.* And because U.S. and U.K. tax principles are materially analogous, "a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts." *Id.* at 238. The windfall tax "*only* reached—and only *could* reach—utilities that realized a profit in the relevant period, calculating profit in the ordinary sense." *Id.* at 236. In short, in every sense that matters under the regulation's "predominant character" standard, the windfall tax operates exactly like a 51.75% tax on excess profits.

That the tax does so is no mere coincidence. The Labour Party intentionally designed the windfall tax to operate as a tax on a subset of the net profits realized by each company during the initial period after its privatization, when profits were deemed excessive. For years before it enacted the tax, the Labour Party campaigned on a promise to impose a "windfall levy on the *excess profits* of the privatised utilities." JA118 (emphasis added). And when the leaders of the Labour Party hired Arthur Andersen to craft the promised tax, that is exactly what they instructed the Andersen team to create. As the leaders of that team testified, "[f]rom the start, there was never any doubt that our task was to design a windfall tax on the excess profits of the privatised utilities." JA326; *see also, e.g.*, JA337 ("I was instructed by the Labour team to design a windfall tax on the excess profits of privatised utilities"). And as they further testified, "[t]hat is what we all believed the 'Windfall Tax' to be." JA326; *see also, e.g.*, JA292

("There is, in conclusion, no doubt in my mind that the character of the tax [we] designed was that it was taxing excess profits: that was in reality what we were asked to do and it is what we did."); JA514 ("The whole thing is about the profits. Had there been no excess profit, there would be no tax. Because they [had] excess profits, we had tax.").

Indeed, even after the tax was dressed up in its "value-based" form, the new Labour government continued to make clear that the tax was exactly what the party had promised—*viz.*, a tax on excess profits. When introducing the new government's budget, Chancellor Brown explained that "[o]ur reform of the welfare state ... is funded by a new and one off windfall tax on the *excess profits* of the privatised utilities." JA126 (emphasis added). Inland Revenue referred to "the proposed windfall tax" as a tax "on the *excess profits* of the privatised utilities." JA128 (emphasis added). Paymaster General Robinson described it as "meeting the commitment that we made in our election manifesto to introduce a windfall levy on the *excess profits* of the privatised utilities." JA146 (emphasis added). The true character of the windfall tax was not lost on the Conservative Party either. In protesting that the tax "defined excess profits arbitrarily," Shadow Chancellor of the Exchequer Peter Lilley explained exactly how it operated: "They have taken average profits over four years after flotation. If those profits exceed one ninth of flotation value, the company will pay windfall tax on the excess." JA152.

2. Notwithstanding the indisputable and undisputed fact that the windfall tax operates as a

51.75% tax on excess profits, the Commissioner insists the tax should really be considered a tax on value—specifically, a tax on "the undervaluation of a company at the time of flotation." Cert. Br. for the United States 10–11. That is just a variation on the same flawed contention that the labels and form of a foreign tax trump its substance. While the windfall tax is nominally a tax on the difference between two numbers or "values," one of those figures—"value in profit-making terms"—is measured by the yardstick of a company's reported profits in the initial period following privatization. To treat a tax on that "value" as anything other than a tax on excess profits is to blink reality. "Value in profit-making terms" is simply a novel presentational mechanism the Andersen team designed to isolate excess profits. Pet.App.58–59 n.16; JA292, 350.

The Commissioner noted in his certiorari-stage brief (at 10) that value is often measured by, among other things, the ability of an asset to generate income. But it is an asset's assumed value to generate income in the future—not the fact that it realized a certain amount of income or profits in the past—that is relevant to value. It is for that reason that high-technology companies that have generated little income—and paid little income tax—are sometimes valued highly, while some low-technology companies that have generated substantial income in the past are nonetheless valued lower. That the U.K. tax was assessed on a "value" derived *exclusively* from past, reported profits over a defined period makes clear that the tax is not directed at "value" in any normal or U.S. tax sense of the word. As one of the Andersen team members explained, the tax thus incorporates "an

underlying concept of value (based on actual ex-post earnings) that would be alien to any valuer." JA292; *see also* Pet.App.60–61 n.17 (summarizing testimony from PPL's finance expert that "value in profit-making terms" "is not a standard economic term or concept" and "has no meaning in any other context").

That the U.K. tax operates as a retrospective tax on excess profits, rather than on current "value" in any normal or U.S. tax sense, is underscored by the fact that it ignores a readily available measure of value in the form of the publicly traded price of the companies' stock. Each company was publicly traded on the London Stock Exchange throughout the entire tax period, meaning its fair market value either at a fixed point or throughout the tax period was readily ascertainable by reference to the price at which its shares were traded, which reflected an estimate of future profitability and a host of other factors (including the likelihood of future windfall profits taxes) that determine present value. Nonetheless, the windfall tax wholly ignores a company's publicly traded stock price and employs a "valuation" formula that produces a figure with no discernible relationship to any standard measure of value. *See* JA472–75. That is because, as its framers conceded, the point of "value in profit-making terms" was to isolate excess profits for purposes of taxing them, not to assess the companies' true value at flotation in any recognized sense of the term.

B. The Third Circuit Misconstrued and Misapplied Controlling Law.

The Third Circuit did not and could not reject either the Tax Court's careful factual findings or

PPL's irrefutable evidence that the practical and intended operation of the U.K. windfall tax is as a 51.75% tax on excess profits. Instead, it simply rendered all of the findings and evidence irrelevant by accepting the Commissioner's invitation to adopt an approach to creditability that "exemplifies the form-over-substance methodology that the governing regulation and case law eschew," and simultaneously focusing on an inapposite regulatory example that not even the Commissioner considered applicable. *Entergy*, 683 F.3d at 237.

Focusing simplistically on the statutory formula used to compute the windfall tax, and the fact that it multiplies initial period profits by 2.25 (or 9/4) before subtracting flotation value, the court concluded that the tax does not satisfy the gross receipts prong of the regulation because "the calculation of the tax base begins with an amount greater than gross receipts." Pet.App.15. Because the tax is nominally a "23% tax on 2.25 times profit," and 2.25 times profit is "an amount greater than gross receipts," the Third Circuit's analysis was at an end. Pet.App.12, 14–15. Never mind that a 23% tax on 2.25 times profit is the mathematical equivalent of a 51.75% tax on profits. Never mind that profits are less than gross receipts and are calculated in a way that begins with gross receipts. And never mind that the tax is not just "likely," but certain, to reach net gain. Never mind all that. Having accepted the Commissioner's invitation to elevate form over substance, all that mattered to the Third Circuit is that the windfall tax statute *says*

it is a "23% tax on 2.25 times profit" minus flotation value, not a 51.75% tax on excess profit. Pet.App.14.[4]

As already demonstrated, that hyper-formalistic approach and the simplistic conclusion that any tax nominally levied on an amount greater than gross receipts cannot be creditable are irreconcilable with the statute, regulation, and controlling case law. Whether the windfall tax is described as a 23% tax on 2.25 times excess profit or a 51.75% tax on excess profit alone, the fact remains that it is not just "likely," but *certain*, to actually "reach net gain in the normal circumstances in which it applies." § 1.901-2(b)(1). In other words, no matter its label or form, "taxation of net gain is the ultimate objective [and] effect of that tax." *Inland Steel*, 677 F.2d at 80. To render creditability of the tax dependent upon which of two mathematically equivalent formulations the U.K. government chose to employ would violate the long-settled principle that "[t]he label and form of the foreign tax is not determinative," *id.*, and undermine the important uniformity purpose the substance-based approach serves. As the Tax Court explained, any

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[4] As PPL explained in its petition for rehearing, among its many errors, the Third Circuit erroneously restated the windfall tax in a manner that greatly exaggerates tax liability. Based on its mistaken belief that PPL was asking it to "cast flotation value aside," Pet.App.10–11 n.2, the court restated the tax as a 23% tax on "value in profit-making terms" alone (*i.e.*, 2.25 times total period profit), without subtracting flotation value, the key component necessary to determine how much of a company's net realized profit was "excessive." That misformulation would produce a windfall tax liability nearly double the amount actually assessed.

approach under which "the same tax is either creditable or noncreditable, depending on the form in which it is enacted," is wholly "at odds with the predominant character standard set forth in the regulations and applied in the caselaw." Pet.App.83 n.34.

That is all the more true given that both the regulation and the case law explicitly contemplate that the creditability analysis may take into account whether the tax rate effectively compensates for aspects of the tax base that do not mirror U.S. taxes. As the Court of Claims explained in *Bank of America I*, a foreign tax that "embodies within itself (via the rate or otherwise)" elements that ensure that it will reach net gain is creditable, even if the base of that tax does not consist of net gain in the U.S. sense. *Bank of America I*, 459 F.2d at 520–21 (providing as an example of a creditable tax one in which rate was decreased to compensate for increasing base to an amount greater than net profit). The regulation similarly explains—repeatedly—that what matters is whether a tax "is likely to *reach* net gain," § 1.901-2(a)(3)(i) (emphasis added), not the base on which it is imposed. Thus, even a tax that is unambiguously imposed on something greater than net gain, such as gross receipts, remains creditable if, *inter alia*, "the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain" remaining. § 1.901-2(b)(4)(i). That is unquestionably the case here, as the Commissioner "stipulated that none of the 31 companies that paid the windfall tax had a windfall tax liability in excess of its total profits over its initial period." Pet.App.79.

And, of course, this case is far easier than many of the cases contemplated by the regulation. Here, the tax is not calculated based on an actual, real-world base that is greater than profits, like gross receipts. Here, the tax is imposed on a base that consists of an artificial number derived from actual, realized profits. A tax on an artificial "value" derived exclusively from actual, realized profits is no different in substance from a tax directly imposed on the actual, realized profits. It simply defies common sense, and the regulation and the case law, to treat the two differently for purposes of determining whether they result in double taxation.

Nonetheless, the Third Circuit still concluded that it must ignore that the windfall tax operates as a 51.75% tax on actual, realized profits. The court reached that conclusion primarily based on inferences it drew from Example 3 of the regulation's gross receipts test, which it appeared to understand as imposing a rigid requirement that the statutorily described base of a foreign tax can never "begin[] with an amount greater than gross receipts"—even though the regulation says explicitly that a foreign tax "imposed on the basis of amounts described [as gross receipts] satisfies the gross receipts requirement *even if it is also imposed on the basis of some amounts not described*" as gross receipts. § 1.901-2(b)(3)(i) (emphasis added).

Example 3 is neither relevant to this case nor a legitimate basis for the Third Circuit's rigid approach. As the Fifth Circuit explained, Example 3 "do[es] not illustrate the meaning of '*actual* gross receipts'" at all—it instead deals with the discrete concept of

"*imputed* gross receipts." *Entergy*, 683 F.3d at 237–38 (emphasis added); *see* § 1.901-2(b)(3)(i)(B) (tax not imposed on basis of actual gross receipts satisfies gross receipts test if imposed on basis of "[g]ross receipts computed under a method that is likely to produce an amount that is not greater than fair market value"). That concept has no application here because the U.K. windfall tax "at no point imputes gross receipts." *Entergy*, 683 F.3d at 238. It does not need to, because it is based directly on *actual* realized profits, which "were actually known" long before the tax "was even proposed." *Id.* Indeed, the critical "value" that drives the windfall tax formula can be calculated only once historical profits in the four years after privatization are known. And because U.S. and U.K. accounting principles are in all relevant respects the same, "a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts" in the U.S. sense. *Id.* Accordingly, "an example detailing an impermissible method for calculating *imputed* gross receipts (based on historical practices by OPEC countries) is facially irrelevant" to the creditability of the windfall tax. *Id.*; *cf.* Rev. Rul. 78-63, 1978-1 C.B. 228 (describing the types of taxes "intentionally structured to tax artificial or fictitious income" that Example 3 addresses).

In fact, if anything, Example 3 only underscores the problems with the Commissioner's and the Third Circuit's formalistic approach, as the whole point of the examples accompanying the gross receipts test is to explain that a foreign tax does not satisfy (or fails) the gross receipts test just because a foreign country says it is (or is not) based on gross receipts. While certain methods of imputing gross receipts may be

appropriate when actual gross receipts are "difficult to calculate or impractical to know," some foreign countries have also "use[d] imputed, rather than actual, income formulas ... 'structured to tax artificial or fictitious income' in order to increase domestic tax receipts." *Id.* at 237. By "differentiat[ing] between permissible *imputed* actual gross receipts and impermissible notional amounts," *id.* at 237–38, the gross receipts examples reject a formalistic approach to creditability that would allow foreign countries to use labels and forms to manipulate the analysis. The Third Circuit's reliance on Example 3 to reintroduce that kind of unyielding formalism into the analysis thus is directly contrary to the substance-based approach to creditability that the examples exist to reinforce.

The Third Circuit veered even further off course when it suggested that the U.K. windfall tax is not creditable because it was imposed on a *subset* of initial period profits, rather than on *total* period profits. *See* Pet.App.10–11 n.2. By that logic, an excess profits tax would *never* be creditable, as a tax on "excess" profits is, by definition, a tax on less than total profits, because it assumes some rate of "normal" profit and imposes a surtax only on the excess. Indeed, the Third Circuit seemed to contemplate exactly that, and even went so far as to suggest PPL should have challenged the validity of the regulation on the ground that it effectively eliminated the credit for excess profits taxes. *Id.*

PPL did not raise any such challenge because the regulation neither compels nor supports that impermissible conclusion. The regulation is focused

on identifying situations in which a tax nominally on something like gross receipts is "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). So long as what a tax reaches is in fact net gain, it is irrelevant what percentage of that net gain it reaches. That much is clear from the case law, which repeatedly states that under the statute a tax need only reach "*some* net gain" to be creditable. *Bank of America II*, 61 T.C. at 760 (quoting *Bank of America I*, 459 F.2d at 523) (emphasis added); *see also Inland Steel*, 677 F.2d at 84 (examining whether tax "ha[d] the effect of falling on *some* net gain" (emphasis added)); § 1.901-2(b)(4)(i) (tax satisfies net income prong when it "is almost certain to reach *some* net gain" (emphasis added)). And it is equally clear from the fact that any other reading of the regulation would, as even the Third Circuit recognized, *see* Pet.App.10–11 n.2, render it irreconcilable with the statute, which explicitly allows a credit for "excess profits taxes." 26 U.S.C. § 901(b)(1).

At bottom, in searching for some basis to accept the Commissioner's fundamentally erroneous position, the Third Circuit arrived at a decision that is wholly at odds with the regulation and the long-standing case law interpreting section 901. While the Third Circuit paid lip service to the rule that the "classification of a foreign tax hinges on its economic substance, not its form," Pet.App.9, it nonetheless treated the form of the windfall tax as dispositive of its substance. Contrary to the statute and the regulation itself, the court read the regulation to render the practical operation of the tax as an excess profits tax legally irrelevant. To sustain that approach would be to eviscerate the fundamental rule that the creditability

of a foreign tax should not "depend upon its characterization by the foreign statutes." *Biddle*, 302 U.S. at 578.

CONCLUSION

The Court should reverse the decision below and hold the U.K. windfall tax creditable.

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December 13, 2012

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26 U.S.C. § 901

Taxes of foreign countries and of possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) Resident of the United States or Puerto Rico

In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) Alien resident of the United States or Puerto Rico

In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and

(4) Nonresident alien individuals and foreign corporations

In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and

(5) Partnerships and estates

In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by

the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

(c) Similar credit required for certain alien residents

Whenever the President finds that—

(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country, the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign

country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of dividends from a DISC or former DISC

For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992(a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign taxes on mineral income

(1) Reduction in amount allowed

Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which—

(A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds

(B) the amount of the tax computed under this chapter with respect to such income.

(2) Foreign mineral income defined

For purposes of paragraph (1), the term "foreign mineral income" means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to—

(A) dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and

(B) that portion of the taxpayer's distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain payments for oil or gas not considered as taxes

Notwithstanding subsection (b) and sections 902 and 960, the amount of any income, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275(a) and this section if—

(1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies, and

(2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain taxes paid with respect to distributions from possessions corporations

(1) In general

For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation—

(A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

(B)(i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

(ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized, shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.

(2) Possessions corporation

For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during which section 931 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) applied to such corporation, or during which section 957(c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) applied to such corporation.

[(h) Repealed. Pub. L. 110-172, § 11(g)(9), Dec. 29, 2007, 121 Stat. 2490]

(i) Taxes used to provide subsidies

Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent—

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

(j) Denial of foreign tax credit, etc., with respect to certain foreign countries

(1) In general

Notwithstanding any other provision of this part—

(A) no credit shall be allowed under subsection (a) for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under section 902 or 960) to any country if such taxes are with respect to income attributable to a period during which this subsection applies to such country, and

(B) subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country.

(2) Countries to which subsection applies

(A) In general

This subsection shall apply to any foreign country—

(i) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,

(ii) with respect to which the United States has severed diplomatic relations,

(iii) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or

(iv) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which

repeatedly provides support for acts of international terrorisms.

(B) Period for which subsection applies

This subsection shall apply to any foreign country described in subparagraph (A) during the period—

(i) beginning on the later of—

(I) January 1, 1987, or

(II) 6 months after such country becomes a country described in subparagraph (A), and

(ii) ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer described in subparagraph (A).

(3) Taxes allowed as a deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(4) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations which treat income paid through 1 or more entities as derived from a foreign country to which this subsection applies if such income was, without regard to such entities, derived from such country.

(5) Waiver of denial

(A) In general

Paragraph (1) shall not apply with respect to taxes paid or accrued to a country if the President—

(i) determines that a waiver of the application of such paragraph is in the national interest of the United States and will expand trade and investment opportunities for United States companies in such country; and

(ii) reports such waiver under subparagraph (B).

(B) Report

Not less than 30 days before the date on which a waiver is granted under this paragraph, the President shall report to Congress—

(i) the intention to grant such waiver; and

(ii) the reason for the determination under subparagraph (A)(i).

(k) Minimum holding period for certain taxes on dividends

(1) Withholding taxes

(A) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax

on a dividend with respect to stock in a corporation if—

(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(B) Withholding tax

For purposes of this paragraph, the term "withholding tax" includes any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

(2) Deemed paid taxes

In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if—

(A) any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

(B) the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

(3) 45-day rule in the case of certain preference dividends

In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied—

(A) by substituting "45 days" for "15 days" each place it appears, and

(B) by substituting "91-day period" for "31-day period".

(4) Exception for certain taxes paid by securities dealers

(A) In general

Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a business as a securities dealer of any person—

(i) who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

(ii) who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or (iii) who is licensed or authorized in such foreign country to conduct securities activities in such country and is

subject to bona fide regulation by a securities regulating authority of such country.

(B) Qualified tax

For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(5) Certain rules to apply

For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246(c) shall apply.

(6) Treatment of bona fide sales

If a person's holding period is reduced by reason of the application of the rules of section 246(c)(4) to any contract for the bona fide sale of stock, the determination of whether such

person's holding period meets the requirements of paragraph (2) with respect to taxes deemed paid under section 902 or 960 shall be made as of the date such contract is entered into.

(7) Taxes allowed as deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(*l*) Minimum holding period for withholding taxes on gain and income other than dividends etc.

(1) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if—

(A) such property is held by the recipient of the item for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

(2) Exception for taxes paid by dealers

(A) In general

Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

(B) Qualified tax

For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Dealer

For purposes of subparagraph (A), the term "dealer" means—

(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof, and

(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

(D) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(3) Exceptions

The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

(4) Certain rules to apply

Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

(5) Determination of holding period

Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule.

(m) Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions

(1) In general

In the case of a covered asset acquisition, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets—

(A) shall not be taken into account in determining the credit allowed under subsection (a), and

(B) in the case of a foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), shall not be taken into account for purposes of section 902 or 960.

(2) Covered asset acquisition

For purposes of this section, the term "covered asset acquisition" means—

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which—

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

(D) to the extent provided by the Secretary, any other similar transaction.

(3) Disqualified portion

For purposes of this section—

(A) In general

The term "disqualified portion" means, with respect to any covered asset acquisition, for any taxable year, the ratio (expressed as a percentage) of—

(i) the aggregate basis differences (but not below zero) allocable to such taxable year under subparagraph (B) with respect to all relevant foreign assets, divided by

(ii) the income on which the foreign income tax referred to in paragraph (1) is determined (or, if the taxpayer fails to substantiate such income to the satisfaction of the Secretary, such income shall be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction).

(B) Allocation of basis difference

For purposes of subparagraph (A)(i)—

(i) In general

The basis difference with respect to any relevant foreign asset shall be allocated to taxable years using the applicable cost recovery method under this chapter.

(ii) Special rule for disposition of assets

Except as otherwise provided by the Secretary, in the case of the disposition of any relevant foreign asset—

(I) the basis difference allocated to the taxable year which includes the date of such disposition shall be the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset which has been allocated under clause (i) to all prior taxable years, and

(II) no basis difference with respect to such asset shall be allocated under clause (i) to any taxable year thereafter.

(C) Basis difference

(i) In general

The term "basis difference" means, with respect to any relevant foreign asset, the excess of—

(I) the adjusted basis of such asset immediately after the covered asset acquisition, over

(II) the adjusted basis of such asset immediately before the covered asset acquisition

(ii) Built-in loss assets

In the case of a relevant foreign asset with respect to which the amount described in clause (i)(II) exceeds the amount described in clause (i)(I), such excess shall be taken into account under this subsection as a basis difference of a negative amount.

(iii) Special rule for section 338 elections

In the case of a covered asset acquisition described in paragraph (2)(A), the covered asset acquisition shall be treated for purposes of this subparagraph as occurring at the close of the acquisition date (as defined in section 338(h)(2)).

(4) Relevant foreign assets

For purposes of this section, the term "relevant foreign asset" means, with respect to any covered asset acquisition, any asset (including any goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the foreign income tax referred to in paragraph (1).

(5) Foreign income tax

For purposes of this section, the term "foreign income tax" means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States.

(6) Taxes allowed as a deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(7) Regulations

The Secretary may issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this subsection, including to exempt from the application of this subsection certain covered asset acquisitions, and relevant foreign assets with respect to which the basis difference is de minimis.

(n) Cross reference

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2) For right of each partner to make election under this section, see section 703(b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a).

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation or partnership controlled by him, see section 6038.

Relevant Excerpts of Treas. Reg. § 1.901-2

(a) Definition of income, war profits, or excess profits tax—(1) In general. Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section and §§ 1.901-2A and 1.903-1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if—

(i) It is a tax; and

(ii) The predominant character of that tax is that of an income tax in the U.S. sense. Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms "paid by," "foreign country," and "foreign levy." Paragraph (h) of this section states the effective date of this section.

(2) Tax—

(i) In general. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority

of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is

allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901-2A.

(ii) Dual capacity taxpayers—

(A) In general. For purposes of this section and §§ 1.901-2A and 1.903-1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a "dual capacity taxpayer." Dual capacity taxpayers are subject to the special rules of § 1.901-2A.

(B) Specific economic benefit. For purposes of this section and §§ 1.901-2A and 1.903-1, the term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic

benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) Pension, unemployment, and disability fund payments. A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) Control of property. A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) Indirect receipt of a benefit. A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person—

(1) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(2) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) Predominant character. The predominant character of a foreign tax is that of an income tax in the U.S. sense—

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) Net gain—(1) In general. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) Realization—

(i) In general. A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—

(A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the

foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and—

(1) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(2) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph

(a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) Certain deemed distributions. A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.*, by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.*, an actual distribution), impose tax ("second tax") with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(iii) Readily marketable property. Property is readily marketable if—

(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iv) Examples. The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example 1. Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows:

A, a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, A pays 2u for 1983 (10 percent of (120u–100u)), 3.5u for 1984 (10 percent of (155u–120u)), and nothing in

1985 because no stock was held at the end of that year. For purposes of the income tax, A must include 60u (160u–100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because country X imposes a second tax upon the occurrence of a later event (*i.e.*, the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

Example 2. The facts are the same as in example 1 except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, A includes only 5u (160u–155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example 3. Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits

tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income (*i.e.*, by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization requirement.

Example 4. Country X imposes a tax on the realized net income of corporations that do business in country X (the "country X corporate tax"). Country X also imposes a separate tax on shareholders of such corporations (the "country X shareholder tax"). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (*i.e.*, income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The

deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(3) Gross receipts—(i) In general. A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) Examples. The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example 1. Country X imposes a "headquarters company tax" on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length

gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example 2. The facts are the same as in Example 1, with the added fact that in the case of a particular taxpayer, A, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example 1 for all persons subject to the headquarters company tax, including A.

Example 3. Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not

satisfy the gross receipts requirement. However, if the tax satisfies the criteria of § 1.903-1(a), it is a tax in lieu of an income tax.

(4) Net income—(i) In general. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit—

> (A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or
>
> (B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the

Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax,

provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) Consolidation of profits and losses. In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (*e.g.*, a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (*e.g.*, a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (*e.g.*, oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e.g.*, oil and gas refining and processing), or whether a person's business profits and losses and its passive

investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) Carryovers. In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) Examples. The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example 1. Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses (e.g., interest expense) attributable to their interest income. The bank tax neither provides for recovery of

significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example 2. Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example 1, the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example 3. A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain. Accordingly, the tax satisfies the net income requirement.

Example 4. Country X imposes a tax at the rate of 48 percent of the "taxable income" of nonresidents of country X who furnish specified types of services to customers who are residents of country X. "Taxable income" for purposes of the tax is defined as gross receipts received from residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisfies the net income requirement.

Example 5. Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the "country X income tax" and the "province Y income tax," respectively. Each tax has an identical base, which is computed by reducing

a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

* * *

(d) Separate Levies. (1) In general. For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. A levy imposed by one taxing authority (e.g., the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (e.g., a political subdivision of that foreign country). Levies are not separate merely because different rates apply to different taxpayers. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding the levy has graduated rates

and applies different rate schedules to unmarried individuals, married individuals who file separate returns and married individuals who file joint returns. In general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (e.g., section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B) and 465(a)(1)(C), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (e.g., section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)). However, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of sections 901 and 903 to impose separate levies for such classes of persons. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies,

because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of § 1.903-1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, e.g., wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also § 1.901-2A(a).

(2) Contractual modifications. Notwithstanding paragraph (d)(1) of this section, if foreign law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then foreign law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply. In applying the provisions of paragraph (c) of this section to a tax as modified by such a contract, the provisions of § 1.903-1(b)(2) shall apply.

(3) Examples. The provisions of paragraph (d)(1) of this section may be illustrated by the following examples:

Example (1). A foreign statute imposes a levy on corporations equal to the sum of 15% of the corporation's realized net income plus 3% of its net worth. As the levy is the sum of two separately computed amounts, each of which is computed by reference to a separate base, each of the portion of the levy based on income and the portion of the levy based on net worth is considered, for purposes of sections 901 and 903, to be a separate levy.

Example (2). A foreign statute imposes a levy on nonresident alien individuals analogous to the taxes imposed by section 871 of the Internal Revenue Code. For the same reasons as set forth in example (1), each of the portion of the foreign levy analogous to the tax imposed by section 871(a) and the portion of the foreign levy analogous to the tax imposed by sections 871 (b) and 1, is considered, for purposes of sections 901 and 903, to be a separate levy.

Example (3). A single foreign statute or separate foreign statutes impose a foreign levy that is the sum of the products of specified rates applied to specified bases, as follows:

Base	*Rate*
Net income from mining	45%
Net income from manufacturing	50%
Net income from technical services	50%
Net income from other services	45%

Net income from investments 15%

All other net income 50%

In computing each such base, deductible expenditures are allocated to the type of income they generate. If allocated deductible expenditures exceed the gross amount of a specified type of income, the excess may not be applied against income of a different specified type. Accordingly, the levy is the sum of several separately computed amounts, each of which is computed by reference to a separate base. Each of the levies on mining net income, manufacturing net income, technical services net income, other services net income, investment net income and other net income is, therefore, considered, for purposes of sections 901 and 903, to be a separate levy.

Example (4). The facts are the same as in example (3), except that excess deductible expenditures allocated to one type of income are applied against other types of income to which the same rate applies. The levies on mining net income and other services net income together are considered, for purposes of sections 901 and 903, to be a single levy since, despite a separate preliminary computation of the bases, by reason of the permitted application of excess allocated deductible expenditures, the bases are not separately computed. For the same reason, the levies on manufacturing net income, technical services net income and other net income together are considered, for purposes of sections 901 and 903, to be a single levy. The levy on investment net income is considered, for purposes of sections 901 and 903, to be a separate levy. These results are not

dependent on whether the application of excess allocated deductible expenditures to a different type of income, as described above, is permitted in the same taxable period in which the expenditures are taken into account for purposes of the preliminary computation, or only in a different (e.g., later) taxable period.

Example (5). The facts are the same as in example (3), except that excess deductible expenditures allocated to any type of income other than investment income are applied against the other types of income (including investment income) according to a specified set of priorities of application. Excess deductible expenditures allocated to investment income are not applied against any other type of income. For the reason expressed in example (4), all of the levies are together considered, for purposes of sections 901 and 903, to be a single levy.

* * *

(f) Taxpayer. (1) In general. The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax. For purposes of this section, § 1.901-2A and § 1.903-1, the person on whom foreign law imposes such liability is referred to as the "taxpayer." A foreign tax of a type described in paragraph (a)(2)(ii)(C) of this section is considered to be imposed on the recipients of wages if such tax is deducted from such wages under provisions that are comparable to section 3102 (a) and (b) of the Internal Revenue Code.

(2) Party undertaking tax obligation as part of transaction— (i) In general. Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See § 1.901-2A for additional rules regarding dual capacity taxpayers.

(ii) Examples. The provisions of paragraphs (f)(1) and (2)(i) of this section may be illustrated by the following examples:

Example (1). Under a loan agreement between A, a resident of country X, and B, a United States person, A agrees to pay B a certain amount of interest net of any tax that country X may impose on B with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Under the law of country X this tax is imposed on the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest, which is applied to offset the recipient's liability for the tax. Because legal liability for the tax is imposed on the recipient of such interest income, B is the taxpayer with respect to the country X tax imposed on B's interest income from B's loan to A. Accordingly, B's interest income for federal income

tax purposes includes the amount of country X tax that is imposed on B with respect to such interest income and that is paid on B's behalf by A pursuant to the loan agreement, and, under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by B.

Example (2). The facts are the same as in example (1), except that in collecting and receiving the interest B is acting as a nominee for, or agent of, C, who is a United States person. Because C (not B) is the beneficial owner of the interest, legal liability for the tax is imposed on C, not B (C's nominee or agent). Thus, C is the taxpayer with respect to the country X tax imposed on C's interest income from C's loan to A. Accordingly, C's interest income for federal income tax purposes includes the amount of country X tax that is imposed on C with respect to such interest income and that is paid on C's behalf by A pursuant to the loan agreement. Under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by C. No such tax is considered paid by B.

Example (3). Country X imposes a tax called the "country X income tax." A, a United States person engaged in construction activities in country X, is subject to that tax. Country X has contracted with A for A to construct a naval base. A is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of § 1.901-2A, A has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together

constitute a single levy. A has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X tax liability that A may incur with respect to A's income from the contract. For federal income tax purposes, A's income from the contract includes the amount of tax liability that is imposed by country X on A with respect to its income from the contract and that is assumed by country X; and for purposes of section 901 the amount of such tax liability assumed by country X is considered to be paid by A. By reason of paragraph (f)(2)(i) of this section, country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to A.

(3) Taxes paid on combined income. If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.

* * *

Relevant Excerpts of Finance (No. 2) Act, 1997, c. 58 (U.K.)

An Act to grant certain duties, to alter other duties, and to amend the law relating to the National Debt and the Public Revenue, and to make further provision in connection with Finance.

[31st July 1997]

Most Gracious Sovereign,

WE, Your Majesty's most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, towards raising the necessary supplies to defray Your Majesty's public expenses, and making an addition to the public revenue, have freely and voluntarily resolved to give and grant unto Your Majesty the several duties hereinafter mentioned; and do therefore most humbly beseech Your Majesty that it may be enacted, and be it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

PART I

THE WINDFALL TAX

1.—Charge to windfall tax.

(1) Every company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation shall be charged with a tax (to be known as the "windfall tax") on the amount of that windfall.

(2) Windfall tax shall be charged at the rate of 23 per cent.

(3) Schedule 1 to this Act (which sets out how to quantify the windfall from which a company was benefitting on 2nd July 1997) shall have effect.

2.—The companies benefitting from windfalls.

(1)For the purposes of this Part a company in existence on 2nd July 1997 was benefitting on that date from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation if—

(a) that company, or a company of which it was on that date a demerged successor, had before that date been privatised by means of a flotation;

(b) there had, before that flotation, been a statutory transfer of property, rights and liabilities from a public corporation to the floated company or to a company which, at the time of the flotation, was a subsidiary undertaking of the floated company; and

(c) at the time of the flotation, the floated company was carrying on an undertaking whose privatisation involved the imposition of economic regulation.

(2) For the purposes of this Part a company was privatised by means of a flotation if—

(a) an offer of shares in that company was at any time made to the public in the United Kingdom;

(b) the shares which were the subject-matter of the offer were publicly-owned at the time of the offer;

(c) the offer was or included an offer of shares for disposal at a fixed price; and

(d) shares in that company were first admitted to listing on the Official List of the Stock Exchange in pursuance of an application made in connection with the offer.

(3) In this Part references, in relation to a company privatised by means of a flotation, to the time of the company's flotation are references to the time when shares in the floated company were first admitted to listing on the Official List of the Stock Exchange.

(4) For the purposes of this Part a company in existence on 2nd July 1997 ("the relevant company") was on that date a demerged successor of a company privatised by means of a flotation if—

(a) after the flotation of the floated company but before 2nd July 1997, there had been a statutory transfer of property, rights and liabilities from the floated company to a company ("the transferee company") which was a subsidiary undertaking of the floated company at the time of the transfer;

(b) the transferee company was not a subsidiary undertaking of the floated company on 2nd July 1997 but was, on that date, a subsidiary undertaking of the relevant company; and

(c) before 2nd July 1997 shares in the relevant company had been admitted to listing on the Official List of the Stock Exchange in pursuance of an application made in connection with the transaction, or series of transactions, by virtue of which the transferee company ceased to be a subsidiary undertaking of the floated company.

(5) For the purposes of this section a company was, at the time of its flotation, carrying on an undertaking whose privatisation involved the imposition of economic regulation if that company, or a company which at that time was a subsidiary undertaking of that company, was at that time—

(a) a public telecommunications operator, within the meaning of the [M1]Telecommunications Act 1984;

(b) an airport operator in relation to an airport subject to economic regulation under Part IV of the [M2]Airports Act 1986;

(c) the holder of an authorisation granted under section 7 of the [M3]Gas Act 1986, as originally enacted (public gas suppliers);

(d) the holder of an appointment under section 11 of the [M4]Water Act 1989 as the water undertaker for any area of England and Wales;

[M1] 1984 c.12.

[M2] 1986 c.31.

[M3] 1986 c.44.

(e) the holder of a licence granted under section 6 of the [M5]Electricity Act 1989 or Article 10 of the [M6]Electricity (Northern Ireland) Order 1992 (licences authorising generation, transmission and supply of electricity); or

(f) a company authorised by a licence under section 8 of the [M7]Railways Act 1993 to be the operator of a railway asset.

(6) In subsection (5) above "airport operator" has the [M8]same meaning as in the Airports Act 1986.

3.—Administration of the windfall tax etc.

(1) The windfall tax shall be under the care and management of the Commissioners of Inland Revenue.

(2) Schedule 2 to this Act (which makes provision with respect to the management and collection of the windfall tax) shall have effect.

(3) Subject to paragraph 19(5) of Schedule 8 to the Taxes Act 1988 (which is the provision about profit-related pay schemes that is amended by section 4 below), nothing in this Act or the Tax Acts shall have the effect of allowing or requiring any

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[M4] 1989 c.15.

[M5] 1989 c. 29.

[M6] S.I. 1992/231 (N.I. 1).

[M7] 1993 c. 43.

[M8] 1986 c. 31.

amount of windfall tax to be deducted in computing income, profits or losses for any of the purposes of the Tax Acts.

4.—The windfall tax and profit-related pay.

(1) In paragraph 19 of Schedule 8 to the Taxes Act 1988 (ascertainment of profits for the purposes of profit-related pay schemes)—

(a) in sub-paragraph (5)(b), after "1985" there shall be inserted "or section 3(3) of the Finance (No. 2) Act 1997"; and

(b) after paragraph (ff) of sub-paragraph (6) there shall be inserted the following paragraph—

"(fg) windfall tax charged under Part I of the Finance (No. 2) Act 1997;".

(2) Subsection (1) above has effect in relation to the preparation, for the purposes of any scheme, of a profit and loss account for any period ending on or after 2nd July 1997.

(3) Subsection (1) above shall not have effect in relation to an existing scheme unless, before the end of the period of six months beginning with the day on which this Act is passed, the scheme is altered, with effect for all periods ending on or after 2nd July 1997, to take account of that subsection.

(4) Provision made, in compliance with paragraph 20(1) of Schedule 8 to the Taxes Act 1988 (consistency in preparation of accounts), by any existing scheme that is altered to take account of subsection (1) above shall not prevent a profit and loss account from being prepared in accordance with the alteration.

(5) An alteration of an existing scheme to take account of subsection (1) above shall be treated as being within section 177B of the Taxes Act 1988 (alterations which are registrable and which, when registered, cannot give rise to the Board's power of cancellation).

(6) In this section "existing scheme" means a scheme which at any time in the period beginning with 2nd July 1997 and ending immediately before the day on which this Act is passed was a registered scheme under Chapter III of Part V of the Taxes Act 1988.

(7) The preceding provisions of this section shall cease to have effect, in accordance with the notes to Part VI(3) of Schedule 18 to the [M9]Finance Act 1997, as if they were included in the repeal of Schedule 8 to the Taxes Act 1988.

5.—Interpretation of Part I

(1) In this Part—

"company" means a company within the meaning of the [M10]Companies Act 1985 or the [M11]Companies (Northern Ireland) Order 1986;

"fixed price", in relation to any offer of publicly-owned shares in a company, means—

(a) a price set out in the offer; or

[M9] 1997 c.16.

[M10] 1985 c. 6.

[M11] S.I. 1986/1032 (N.I. 6).

(b) a price subsequently fixed by a Minister of the Crown in a case in which the amount of a first instalment of the price was fixed by the offer;

"the floated company", in relation to the privatisation of a company by means of a flotation, means the company so privatised;

"public corporation", in relation to a statutory transfer, means any body corporate in existence at the time of the transfer which—

(a) had been established by or in accordance with the provisions of any enactment; and

(b) had a membership consisting of, or including, persons appointed as members by a Minister of the Crown;

"publicly-owned", in relation to any shares, means held by—

(a) a Minister of the Crown or the Treasury; or

(b) a nominee for a Minister of the Crown or for the Treasury;

"share" includes any right to require the issue of a share;

"statutory transfer" means a transfer under a transferring enactment or by or in accordance with a statutory scheme;

"subsidiary undertaking"—

(a) except in relation to a company formed and registered in Northern Ireland, means a

subsidiary undertaking within the meaning of Part VII of the Companies Act 1985; and

(b) in relation to a company so formed and registered, means a subsidiary undertaking within the meaning of Part VIII of the Companies (Northern Ireland) Order 1986.

(2) In this section—

"enactment" means an enactment contained in a public general Act or any provision of Northern Ireland legislation;

"Minister of the Crown" includes a Northern Ireland department or the head of such a department;

"statutory scheme" means any scheme which—

(a) has been made in exercise of any power or duty conferred or imposed by any enactment;

(b) contains provision for the division of property, rights and liabilities between different persons, or for the transfer of property, rights and liabilities to a company; and

(c) would not have taken effect or come into force but for having been approved by a Minister of the Crown;

"transferring enactment" means an enactment under which property, rights and liabilities of a person specified in the enactment became, by virtue of that enactment, the property, rights or liabilities of a company nominated under that enactment.

(3) In subsection (2) above the reference, in relation to a scheme, to its having been approved by a

Minister of the Crown includes a reference to its having been made by a Minister of the Crown.

(4) The reference in subsection (1) above to Part VII of the [M12]Companies Act 1985 shall be construed, in relation to times in relation to which that Part had effect without the amendments made by the [M13]Companies Act 1989, as if those amendments did have effect in relation to those times.

* * *

SCHEDULE 1

Section 1.

QUANTIFICATION OF A PRIVATISATION WINDFALL

The basic rule

1 (1) Subject to paragraph 7 below, where a company was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation, the amount of that windfall shall be taken for the purposes of this Part to be the excess (if any) of the amount specified in sub- paragraph (2)(a) below over the amount specified in sub-paragraph (2)(b) below.

(2) Those amounts are the following amounts (determined in accordance with paragraphs 2 to 6 below), that is to say—

[M12] 1985 c. 6.

[M13] 1989 c. 40.

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and

(b) the value which for privatisation purposes was put on that disposal.

Value of a disposal in profit-making terms

2 (1) Subject to paragraph 4 below, the value in profit-making terms of the disposal made on the occasion of a company's flotation is the amount produced by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio.

(2) For the purposes of this paragraph the average annual profit for a company's initial period is the amount produced by the following formula—

$A = 365 \times P/D$

Where—

A is the average annual profit for the company's initial period;

P is the amount, ascertained in accordance with paragraph 5 below, of the total profits for the company's initial period; and

D is the number of days in the company's initial period.

(3) For the purposes of this paragraph the applicable price-to-earnings ratio is 9.

Value put on a disposal for privatisation purposes

3 (1) Subject to paragraph 4 below, the value which for privatisation purposes was put on the

disposal made on the occasion of a company's flotation is the amount produced by multiplying the institutional price by the number of shares comprised in the ordinary share capital of the company at the time of its flotation.

(2) In this paragraph "the institutional price", in relation to a company, means the highest fixed price per share at which publicly-owned shares in the company were offered for disposal on the occasion of the company's flotation.

(3) Subject to sub-paragraph (4) below, where publicly-owned shares in a company were offered for disposal in accordance with any arrangements for the payment of the price in two or more instalments, the price per share at which those shares were offered shall be ascertained by aggregating the instalments.

(4) Where the arrangements under which any publicly-owned shares in a company were offered for disposal provided for any discount on the payment of the whole or any part of the price for those shares, that discount shall be disregarded for the purposes of this paragraph in determining the price per share at which those shares were offered.

Cases where company privatised in stages

4 (1) For the purposes of this Schedule, where the disposal percentage in the case of any company was 85 per cent. or less—

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation, and

(b) the value which for privatisation purposes was put on that disposal, shall each be taken to be the disposal percentage of the amount which, under paragraph 2 or 3 above, would be the amount of that value but for this paragraph.

(2) For the purposes of this paragraph "the disposal percentage", in relation to any company, means the percentage which expresses (in terms of nominal value) how much of the ordinary share capital of the company at the time of its flotation was represented by the publicly-owned shares in the company offered for disposal on the occasion of the company's flotation.

Total profits for the initial period

5 (1) For the purposes of paragraph 2 above the amount of the total profits for a company's initial period is the sum of the amounts falling within sub-paragraph (2) below.

(2) Subject to sub-paragraph (3) and paragraph 6(3) below, those amounts are every amount which, for a financial year of the company ending in or at the end of its initial period, is shown in the relevant accounts for that year—

(a) where those accounts are prepared in accordance with section 227 of the [M46]Companies Act 1985 (group accounts), as the profit of that company and its subsidiary undertakings for that year; and

---

[M46] 1985 c. 6.

(b) in any other case, as the profit of that company for that year.

(3) Where—

(a) any profit shown in the relevant accounts of a company for any financial year has been computed using a current cost accounting method, but

(b) the information which was contained in those accounts, or which was provided to the registrar together with those accounts, included information from which it can be ascertained what that profit would have been if an historical cost accounting method had been used,

the amount shown as that profit in those accounts shall be deemed to be the amount (as ascertained from that information) which would have been so shown if that historical cost accounting method had been used.

(4) In this paragraph references, in relation to any financial year of a company, to the relevant accounts are references to any such accounts for that year as have been or are delivered to the registrar under section 242 of the Companies Act 1985 and consist—

(a) in the case of a financial year at the end of which the company was a parent undertaking, in consolidated group accounts prepared in accordance with section 227 of that Act (group accounts); and

(b) in any other case, in accounts prepared in accordance with section 226 of that Act (individual accounts).

(5) Subject to sub-paragraph (6) below, references in this paragraph to the amount shown in any accounts as the profit for any financial year are references to the amount of the profit (if any) for that year which is set out in the profit and loss account comprised in those accounts as the item which is, or is the equivalent of, the final item of the statutory format which for that year was used for that profit and loss account.

(6) Where any amount shown in any accounts is less than it would have been if no provision or other deduction had been made—

(a) in relation to the windfall tax, or

(b) in anticipation of the imposition of a charge with characteristics similar to those of the windfall tax,

this Schedule shall have effect as if the amount shown were the amount it would have been if that provision or deduction had not been made.

(7) Nothing in this paragraph shall, in the case of any company—

(a) prevent any charge to windfall tax from being treated as having arisen on 2nd July 1997 by reference to accounts delivered to the registrar after that date; or

(b) prevent any requirement to pay an instalment of windfall tax, or any other liability under Schedule 2 to this Act, from arising before

the delivery to the registrar of the accounts by reference to which the amount of that charge is computed;

and any power of the Board under that Schedule to make an assessment shall include power to make an assessment on the basis that accounts will be delivered to the registrar showing such amounts as may, to the best of their judgement, be determined by the Board.

(8) Subject to sub-paragraph (9) below, this paragraph shall have effect in relation to anytime at which the [M47]Companies Act 1985 had effect without the amendments made by the [M48]Companies Act 1989—

(a) as if the references in sub-paragraphs (2) and (4) above to sections 226, 227 and 242 of the Companies Act 1985 were references, respectively, to sections 227, 229 and 241 of that Act, as it had effect without those amendments;

(b) as if the reference in sub-paragraph (2) above to a company's subsidiary undertakings were a reference to its subsidiaries (within the meaning of that Act as it so had effect); and

(c) as if the reference in sub-paragraph (4)(a) above to a company's being a parent undertaking were a reference to its having such subsidiaries.

[M47] 1985 c. 6.

[M48] 1989 c. 40.

(9) In relation to a company formed and registered in Northern Ireland, this paragraph shall have effect as if the references in sub-paragraphs (2) and (4) above to sections 226, 227 and 242 of the Companies Act 1985 were references, respectively, to Articles 234, 235 and 250 of the [M49]Companies (Northern Ireland) Order 1986.

(10) In this paragraph—

"the registrar" means—

(a) except in relation to a company formed and registered in Northern Ireland, the registrar within the meaning of the Companies Act 1985; and

(b) in relation to a company so formed and registered, the registrar within the meaning of the Companies (Northern Ireland) Order 1986;

and

"statutory format", in relation to a profit and loss account, means a format set out in the provisions (as they had effect in relation to that account) of Schedule 4 to the Companies Act 1985 or Schedule 4 to the Companies (Northern Ireland) Order 1986.

Meaning of the initial period etc

6 (1) In this Schedule "initial period", in relation to a company privatised by means of a flotation, means (subject to sub-paragraph (2) below) the period which—

[M49] S.I. 1986/1032 (N.I. 6).

(a) begins with the first day of the first financial year of the company to begin after the time of its flotation; and

(b) ends with the end of the fourth financial year of the company to begin after the time of its flotation.

(2) Where the initial period of a company privatised by means of a flotation would (but for this sub-paragraph) include any time on or after 1st April 1997, sub-paragraph (1) above shall not apply and the initial period of that company shall be taken, instead, to be the period which—

(a) begins with the day on which the time of its flotation falls; and

(b) ends with the end of the last financial year of the company to end before 1st April 1997.

(3) Where—

(a) sub-paragraph (2) above applies for determining a company's initial period, and

(b) there is a financial year of that company beginning before but ending after the beginning of that initial period,

the amount which for that year is shown as mentioned in paragraph 5(2) above shall be included in the sums added together for the purposes of paragraph 5(1) above to the extent only that that amount is attributable, on an apportionment made in accordance with the following provisions of this paragraph, to the part of that year falling within the company's initial period.

(4) Except in a case where sub-paragraph (5) below applies, an apportionment for the purposes of sub-paragraph (3) above shall be made on a time basis according to the respective lengths of—

(a) the part of the financial year falling before the beginning of the company's initial period; and

(b) the remainder of that financial year.

(5) Where the circumstances of a particular case are such that—

(a) the making of an apportionment on the basis mentioned in sub-paragraph (4) above would work in a manner that would be unjust or unreasonable, but

(b) it would be just and reasonable to make the apportionment on the alternative basis,

the apportionment shall be made, instead, on the alternative basis.

(6) For the purposes of this paragraph an apportionment in the case of any company of the amount shown for any financial year as a profit for that year is made on the alternative basis where it is made according to how much of that profit accrued in each of the two parts of that financial year that are mentioned in sub-paragraph (4) above.

Apportionment between demerged successors and predecessors

7 (1) This paragraph applies where—

(a) a company ("the predecessor company") was benefitting on 2nd July 1997 from a windfall

from the flotation of an undertaking whose privatisation involved the imposition of economic regulation; and

(b) another company which on that date was a demerged successor of the predecessor company is also taken for the purposes of this Part to have been benefitting from such a windfall on that date.

(2) Where this paragraph applies—

(a) the amount of the windfall from which the predecessor company was benefitting on 2nd July 1997 shall be equal to only the appropriate fraction of the amount ("the total windfall") which (but for this paragraph) would have been the amount of that windfall under paragraphs 1 to 6 above; and

(b) the amount of the windfall from which the demerged successor shall be taken to have been benefitting on that date shall be equal to the remainder of the total windfall.

(3) In this paragraph "the appropriate fraction" means the following fraction—

P / P+S

Where—

P is the amount produced by multiplying the number of shares comprised at the end of the relevant day in the ordinary share capital of the predecessor company by the market price on that day of an ordinary share in that company; and

S is the amount produced by multiplying the number of shares comprised at the end of the relevant day in the ordinary share capital of the demerged successor by the market price on that day of an ordinary share in the demerged successor.

(4) For the purposes of this paragraph references to the market price of shares on any day are references to the sum of—

(a) the lower of the two prices shown in the Stock Exchange Daily Official List for that day as the closing prices for the shares on that day; and

(b) one half of the difference between those two prices.

(5) In this paragraph "the relevant day" means the day on which shares in the demerged successor were first listed on the Official List of the Stock Exchange.

General interpretation of the Schedule

8 (1) In this Schedule "financial year", in relation to a company, means (subject to sub-paragraph (2) below)—

(a) a financial year of that company within the meaning of Part VII of the [M50]Companies Act 1985; or

(b) any period which—

[M50] 1985 c. 6.

(i) began before the coming into force of section 3 of the [M51]Companies Act 1989 (new definition of financial year); and

(ii) was a financial year of that company for the purposes of that Part, as it had effect without the amendments made by that section.

(2) Sub-paragraph (1) above does not apply to a company formed and registered in Northern Ireland; and in relation to such a company, references in this Schedule to a financial year are references to a financial year within the meaning of Part VIII of the [M52]Companies (Northern Ireland) Order 1986.

(3) In this Schedule references, in relation to a company privatised by means of a flotation, to the shares offered for disposal on the occasion of the company's flotation are references to the following shares in that company, that is to say—

(a) those that were the subject-matter of the offer to the public in respect of which that company is regarded for the purposes of this Part as having been so privatised; and

(b) any publicly-owned shares not falling within paragraph (a) above that were the subject-matter of an offer for disposal made on the same occasion as the offer mentioned in that paragraph.

[M51] 1989 c. 40.

[M52] S.I. 1986/1032 (N.I. 6).

(4) References in this Schedule to an offer for the disposal of shares in a company include references to any offer to transfer or confer an immediate or contingent right to or interest in any such shares, whether or not for a consideration; and (subject to sub-paragraph (5) below) references to the shares that are the subject-matter of such an offer shall be construed accordingly.

(5) For the purposes of sub-paragraph (3) above where—

(a) an offer for the disposal of publicly-owned shares in a company contained provision for a person to become entitled to further shares in that company if he satisfied conditions specified in the offer, and

(b) those conditions included a condition as to the period for which shares in that company continued to be held by that person,

shares which (apart from this sub-paragraph) would fall to be treated as the subject-matter of the offer by virtue only of that provision shall be treated as the subject-matter of the offer to the extent only that persons did in fact become entitled to them before 2nd July 1997 as a result of having satisfied the conditions in question.

(6) In this Schedule a reference, in relation to any time, to the ordinary share capital of a company is a reference to the following, taken together, that is to say—

(a) the shares comprised in the ordinary share capital of the company (within the meaning of the Tax Acts); and

(b) any shares that would have been so comprised at that time if the issued share capital of the company at that time had included any shares in the company that had been allotted but not issued. * * *

RESPONDENT'S BRIEF

No. 12-43

In the Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether the "windfall tax" set forth in the United Kingdom's Finance (No. 2) Act, 1997, c. 58, which imposed on privatized utilities a one-time 23% tax on the difference between a company's profit-making value and its privatization value, is an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-15) is reported at 665 F.3d 60. The opinion of the United States Tax Court (Pet. App. 22-87) is reported at 135 T.C. 304.

JURISDICTION

The amended judgment of the court of appeals (Pet. App. 16-17) was entered on January 13, 2012. A petition for rehearing was denied on March 9, 2012 (Pet. App. 20-21). On May 10, 2012, Justice Alito extended the time within which to file a petition for a writ of certiorari to and including July 9, 2012, and the petition was filed on that date. The petition for a writ of certiorari was granted on October 29, 2012. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATEMENT

1. Section 901 of the Internal Revenue Code allows a United States citizen or domestic corporation to claim a credit against its United States income-tax liability for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. 901(a) and (b)(1). The goal of the foreign tax credit is to reduce double taxation of foreign-source income paid to U.S. taxpayers. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

In 1983, the Secretary of the Treasury issued a regulation that defines a creditable "income, war profits, or excess profits tax" under Section 901. See 26 C.F.R. 1.901-2. The regulation refers to all three types of taxes as "income tax" and states that a foreign tax "is an income tax if and only if * * * [t]he predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. 1.901-2(a)(1)(ii). That standard is met if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. 1.901-2(a)(3)(i).

The regulation explains that a foreign tax is likely to reach net gain "if and only if the tax, judged on the basis of its predominant character," satisfies each of three tests: the realization test, the gross-receipts test, and the net-income test. 26 C.F.R. 1.901-2(b)(1). The realization test is satisfied if the foreign tax "is imposed * * * [u]pon or subsequent to the occurrence of events * * * that would result in the realization of income under the income tax provisions of the Internal Revenue Code." 26 C.F.R. 1.901-2(b)(2)(i)(A).

The gross-receipts test is satisfied if the foreign tax is imposed on the basis of gross receipts or an equivalent thereof "computed under a method that is likely to

produce an amount that is not greater than [their] fair market value." 26 C.F.R. 1.901-2(b)(3)(i)(A)-(B). The regulation further provides that "[a] foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph * * * satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph." 26 C.F.R. 1.901-2(b)(3)(i).

The net-income test is satisfied if "the base of the tax is computed by reducing gross receipts * * * to permit * * * [r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." 26 C.F.R. 1.901-2(b)(4)(i)(A). The regulation provides that "[a] foreign tax * * * that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses." 26 C.F.R. 1.901-2(b)(4). The regulation further provides that "[a] foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where the tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain." *Ibid.*

2. a. Between 1984 and 1996, the government of the United Kingdom, under the control of the Conservative Party, privatized ownership of more than 50 state-owned companies by "flotation" (*i.e.*, public offering) of their

stock. J.A. 23. The flotation process involved the U.K. government's transfer of the companies' assets to newly created "public limited companies" in exchange for the stock of the new companies. The U.K. government then sold shares in the new companies to the public at a fixed price. J.A. 24, 63-69. In December 1990, the U.K. government privatized twelve regional electric companies, including South Western Electricity plc (SWEB). J.A. 16-17, 24.

The U.K. government regulated the prices that the privatized utilities could charge the public. Pet. App. 2; J.A. 217-222. Nevertheless, because the privatized utilities increased efficiency to a greater degree than had been expected when the initial price controls were established, the companies realized substantially higher profits than had been anticipated. Pet. App. 2-3; J.A. 225-229. It was thus widely believed in the U.K. that the utilities had been sold too cheaply and that their profits were excessive in relation to their flotation value. J.A. 126, 140-141, 531-532, 567; C.A. J.A. 779, 800.

b. In 1996, the Labour Party began to explore the possibility of imposing a "windfall tax" on the privatized utilities, which it promised to enact if restored to power. J.A. 26. Geoffrey Robinson, a member of Parliament and the Labour Party's Paymaster General, hired Arthur Andersen to assist the Labour Party's shadow treasury team in developing a proposal for the tax. *Ibid.*

The Andersen team considered three "simple" and three "complex" solutions for structuring the tax. The three simple solutions were to tax gross receipts, assets, or profits. The three complex solutions were to tax excess profits, excess shareholder returns, or a "windfall" amount. Pet. App. 32-33; J.A. 505-510. The team rejected all three simple solutions and the first two com-

plex solutions. In particular, the team rejected an excess-profits tax because of the difficulty in computing the "excess" amounts and the need for a retrospective tax to be assured of raising a target amount. J.A. 508; C.A. J.A. 321-323, 740. Robinson further testified that an excess-profits tax was rejected because "it could have impacted quite variously on the different companies involved and could have impacted very severely on perhaps even the very survivability of some of them." J.A. 508.

Robinson and the Andersen team settled on a one-time tax that would be charged on the "windfall" that the utilities were thought to have received at privatization. The windfall would be the amount by which an imputed value for each company at privatization (to be determined by applying a selected price-to-earnings ratio to each company's average annual profits over a multi-year period) exceeded the actual flotation price of the company. In other words, the proposal was to tax the difference between the price at which each company was actually sold and an estimated value at which it should have been sold. J.A. 509-510; C.A. J.A. 323-324, 742-743. In its final presentation to Chancellor Gordon Brown, the Andersen team identified the following "windfall principles":

- Impute value of businesses on privatisation
- Recognise the windfall as value forgone by the taxpayer
- Tax the companies on the value forgone using established principles from capital gains tax legislation
- Value could be estimated as profit before tax (PBT) x a multiple

- Windfall at privatisation could be defined as estimated value *less* sales proceeds
- Positive windfall would imply that companies were sold at less than their imputed value.

C.A. J.A. 744-746.

c. In 1997, the Labour Party regained control of the U.K. government. In July 1997, Parliament enacted a "windfall tax" on the privatized utilities as part of the Finance (No. 2) Act, 1997, c. 58 (U.K. Act). See Pet. App. 129-151. The windfall tax was a one-time tax that was required to be paid in two installments: one-half by December 1, 1997, and the other half by December 1, 1998. J.A. 130.

The U.K. Act provides that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." § 1(1) (Pet. App. 129). The amount of the tax was 23% of the "windfall." § 1(2) (Pet. App. 130).

The "windfall"—the base of the tax—is defined as the difference between two values: (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" minus (b) "the value which for privatisation purposes was put on that disposal." U.K. Act Sch. 1, para. 1 (Pet. App. 138-139). As the Board of Inland Revenue explained, "[t]he taxable amount is calculated by taking the value of the company in profit-making term[s] and deducting the value placed on the company at the time of flotation." J.A. 134.

i. The first of those two values (the profit-making value) is determined "by multiplying the average annual profit for the company's initial period by the applicable

price-to-earnings ratio." U.K. Act Sch. 1, para. 2 (Pet. App. 139). A company's "initial period" is generally the first four years after flotation. U.K. Act Sch. 1, para. 6(1) (Pet. App. 145-146). The "average annual profit" during that initial period is equal to the company's total profits for the initial period divided by the number of days in the initial period, multiplied by 365. U.K. Act Sch. 1, para. 2(2) (Pet. App. 139).

That number is multiplied by "the applicable price-to-earnings ratio," which is 9. U.K. Act Sch. 1, para. 2(3) (Pet. App. 139). That figure represents the lowest average price-to-earnings ratio, during the relevant period, of the 32 companies that would be subject to the tax. J.A. 129, 135.

ii. The second of the two values (the flotation value) is determined by multiplying the highest price per share at which shares in the company were offered during flotation by the number of shares that were offered. U.K. Act Sch. 1, para. 3 (Pet. App. 139-140).

The windfall tax can thus be expressed by the following formula, where P is the total profits for the company's initial period, D is the number of days in the initial period, and FV is the company's flotation value (the price for which the U.K. government sold the company):

$$\text{Windfall Tax} = 23\% \times (((365 \times P/D) \times 9) - FV)$$

See Pet. App. 4. Because for most companies the initial period was four years (*i.e.*, four times 365 days plus one leap day), that formula is approximately equal to the following:

$$\text{Windfall Tax} = 23\% \times ((9/4 \times P) - FV)$$

See Pet. Br. 9.

3. SWEB paid a total windfall tax of £90,419,265. J.A. 45. Petitioner, a Pennsylvania corporation with its

principal place of business in Allentown, Pennsylvania, owned a 25% interest in SWEB through petitioner's subsidiaries when the windfall tax was imposed. Pet. App. 87; J.A. 12, 16. Under 26 U.S.C. 902(a), if a U.S. corporation owns at least ten percent of the voting stock of a foreign corporation and receives a dividend from the foreign corporation, the U.S. corporation is deemed to have paid (for purposes of Section 901) a portion of any foreign income tax that the foreign corporation paid on the earnings and profits from which the dividend was paid. In May 2000, petitioner filed a refund claim with the Internal Revenue Service (IRS), treating petitioner's share of the windfall tax paid by SWEB as a creditable foreign income tax. Pet. App. 4; J.A. 47-48. The IRS disallowed the claim and issued a deficiency notice. Pet. App. 4; J.A. 48. Petitioner contested the deficiency notice in the United States Tax Court. Pet. App. 4; J.A. 12.

4. The Tax Court concluded that the U.K. windfall tax was creditable under Section 901. Pet. App. 22-87. The court rejected the Commissioner's argument that the windfall tax was a tax based on value, *i.e.*, a tax on the amount by which SWEB was undervalued at the time of flotation. *Id.* at 79. The court explained that "a foreign levy [can] be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values." *Id.* at 81.

The Tax Court further explained that the windfall tax could be reformulated as a 51.75% tax on a company's profits during the initial period, to the extent those profits exceeded an average annual return of approximately 11.1% of the company's flotation value. Pet. App. 64, 83; see Pet. 8-9. Without evaluating the windfall tax under the realization, gross-receipts, or net-income tests

as required by 26 C.F.R. 1.901-2(b)(1)-(4), the court concluded that the tax "did, in fact, 'reach net gain,'" and was therefore creditable under Section 901. Pet. App. 84 (quoting 26 C.F.R. 1.901-2(a)(1) and (3).[1]

5. The court of appeals reversed. Pet. App. 1-15. As an initial matter, the court explained that the Tax Court had incorrectly applied a "predominant character" standard that was detached from the three regulatory tests mandated by 26 C.F.R. 1.901-2(b)(1)-(4). Pet. App. 6 n.1. The court clarified that, in order to be a creditable income tax under Section 901, a foreign tax must satisfy each of those three tests "bas[ed] on its predominant character." *Ibid.* (quoting 26 C.F.R. 1.901-2(b)(1)-(4)).

The court of appeals further explained that petitioner's position suffered from a "fundamental problem": the court could not arrive at SWEB's initial-period profit as the tax base unless it both ignored the flotation value variable and applied a tax rate different from the 23% rate specified by the statute. Pet. App. 9-10. At petitioner's request, and "[f]or the sake of argument," the court reformulated the windfall-tax formula by plugging in 1461 (the number of days in four years) for *D*, and by disregarding the flotation value (based on petitioner's contention that subtracting the flotation value was simply Parliament's way of taxing "excess"

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[1] On the same day as the Tax Court issued its decision in this case, it issued another decision in favor of a second U.S. taxpayer claiming a foreign tax credit for the windfall tax, relying on its opinion in petitioner's case. See *Entergy Corp.* v. *Commissioner*, 100 T.C.M. (CCH) 202 (2010). The Fifth Circuit affirmed that decision, *Entergy Corp.* v. *Commissioner*, 683 F.3d 233 (2012), and the Commissioner has filed a petition for a writ of certiorari seeking review of the Fifth Circuit's ruling. No. 12-277 (filed Sept. 4, 2012).

profits rather than total profits). *Id.* at 10-11. That reformulation yielded the formula:

$$\text{Tax} = 23\% \ ((365 \times P/1461) \times 9)$$

Id. at 11. Multiplying 365 by 9 and dividing by 1461 reduces that equation to approximately:

$$\text{Tax} = 23\% \times (2.25 \times P)$$

Ibid.

The court of appeals noted that petitioner's reformulation produced a tax base of 2.25 times profit, or 2.25 times gross receipts minus 2.25 times expenses. Pet. App. 12. The court concluded that this reformulation failed the gross-receipts test because that test requires the tax base to be based on gross receipts or an approximation thereof "likely to produce an amount that is *not greater than* [their] fair market value." *Ibid.* (brackets in original) (quoting 26 C.F.R. 1.901-2(b)(3)(i)(B)).

The court of appeals rejected petitioner's further argument that a 23% tax on 2.25 times profits is equivalent to a 51.75% tax on profits, which makes the tax base profits alone. Pet. App. 12. The court declined to view the tax in that way, noting that under petitioner's reformulation, "*[a]ny* tax on a multiple of receipts or profits could satisfy the gross receipts requirement, because we could reduce the starting point of its tax base to 100% of gross receipts by imagining a higher tax rate." *Id.* at 13-14. The court concluded that "[t]he regulation forbids that outcome." *Id.* at 14.

The court of appeals further held that the windfall tax failed to satisfy the realization test, which requires that the foreign tax be "imposed * * * [u]pon or subsequent to the occurrence of events * * * that would result in the realization of income" under U.S. income tax provisions. 26 C.F.R. 1.901-2(b)(2)(i)(A); Pet. App.

14 n.3. The court observed that SWEB's windfall amount subject to tax (£393.1 million) was greater than its total profit during its four-year initial period (£306.2 million). Pet. App. 14 n.3. For that reason, the court stated, "[t]he U.K. windfall tax did not ensure that the companies had actually realized the amount being taxed." *Ibid.*

SUMMARY OF ARGUMENT

A. In the context of U.S. federal and state taxes imposed on the value of property, it is common for value to be determined based on the property's ability to generate income. For example, taxable values of property for purposes of the federal estate and gift taxes are determined pursuant to well-recognized valuation formulas in which income plays an essential role. State property taxes are often calculated pursuant to those same valuation methods.

The "profit-making value" imputed to a company under the U.K. Act is calculated using the "market approach" to valuation, under which the value of property is determined by identifying comparable property and deriving a price-to-earnings multiple that is applied to the subject property's income data. The company's flotation value, calculated by reference to its stock price at the time of issuance, is then subtracted to yield a taxable "windfall" amount. Those are well-recognized methods of establishing a value for property under U.S. tax law.

The fact that actual initial-period profits are used in the windfall-tax calculation does not detract from its character as a valuation formula. Nor does Parliament's decision to forgo the use of other accepted valuation methods show that the windfall tax is anything other than a tax on value. The windfall tax is calculated ac-

cording to established valuation methods that are familiar to U.S. tax law. It is tax on value both in form and in substance.

B. 1. The formula used to compute a company's tax liability under the U.K. Act includes as one variable the company's profits during its initial period after flotation. Contrary to petitioner's argument, however, consideration of company profits for that purpose does not make the windfall tax a tax on income. Whenever the value of taxed property is calculated by reference to the income that the property has produced or is expected to produce, the amount of the tax can always be expressed as a percentage of actual or expected income. That mathematical relationship cannot be enough to transform a tax on value into a tax on income.

The fact that a company's flotation value is taken into account reinforces the conclusion that the windfall tax was not an income tax. If a company's flotation value is high enough, a company that made significant profits would not pay any windfall tax at all. What is important is the value the U.K government received for the company when it was sold, and whether that price accurately reflected the property's value as demonstrated by its ability to produce initial-period income. The flotation value variable also distinguishes the windfall tax from previous U.S. excess-profits taxes, which were historically imposed on a company's net income over a floor. Calculating a company's tax liability by reference to its flotation value is not a reflection of how profitable a company is over a "normal" level. It is a reflection of how valuable a company is in relation to the value the U.K. government received for the company when it was sold.

2. There is likewise no support for petitioner's argument that a foreign tax is "in substance" an income tax so long as it is not confiscatory of net gain. The decisions setting forth a "net gain" standard involve foreign tax statutes that imposed a tax on gross income rather than net income. In that context, courts sometimes found that a gross-income tax could be taxation of income in the U.S. sense. Those decisions do not support the contention that a foreign tax levied on a base other than gross or net income can be considered an income tax simply because the taxpayer is almost certain to be left with some net gain after paying the tax.

C. Under 26 C.F.R. 1.901-2(b)(2)-(4), a foreign tax is likely to reach net gain "if and only if" it satisfies three regulatory tests: the realization test, the gross-receipts test, and the net-income test. The U.K. windfall tax fails all three tests.

1. The windfall tax was not imposed upon or subsequent to a realization event. The flotation of SWEB in 1990 (the relevant event upon which the windfall tax was imposed) was not a realization event for the company, nor did any perceived appreciation in value of the company result in realization of income under U.S. tax law. For 23 of 31 companies that paid the windfall tax, the taxable windfall amount was greater than the company's total profits during the initial period. That fact further demonstrates that the windfall tax was not imposed on realized income.

2. The windfall tax was not imposed on the basis of gross receipts. Although gross receipts were used to compute a company's average annual profits, which was one variable in the windfall-tax formula, the windfall tax was not imposed on the basis of those receipts. The receipts figured into a larger formula that produced a

company value divorced from the concept of gross receipts.

3. The windfall tax fails the net-income test because the base of the tax was not a company's net income. The tax was imposed on a base "windfall" amount that reflected a company's undervaluation at the time of flotation. That number was in most cases greater than a company's total net income during its four-year initial period. Under the regulation, a tax that uses gross income or gross receipts as its base may occasionally satisfy the net-income test. The regulation does not, however, allow a free-wheeling inquiry into whether a tax based on something other than gross income or gross receipts can satisfy the net-income requirement.

D. The legislative history of the U.K. Act does not support petitioner's characterization of the windfall tax as a tax on "excess profits." The legislative history reflects Parliament's views that the companies were sold too cheaply *and* that their initial-period profits were excessive. Although that mix of concerns *might* have led Parliament to enact an excess-profits tax, Parliament instead chose as the tax base an increment of company value. Nothing in the U.K. Act's legislative history justifies disregarding that choice for purposes of Section 901.

E. Disallowing a foreign tax credit for petitioner's portion of the windfall tax paid by SWEB will not result in double taxation. Petitioner received a foreign tax credit for its portion of SWEB's income taxes paid during the years SWEB paid the windfall tax, and petitioner gets the benefit of a deduction for its share of SWEB's windfall tax paid to the U.K. government.

ARGUMENT

THE U.K. WINDFALL TAX IS NOT AN INCOME TAX FOR WHICH A FOREIGN TAX CREDIT IS ALLOWED UNDER 26 U.S.C. 901

The windfall tax is not an income tax; it is a tax on value. That is so both because the U.K. government wrote it as a tax on value and because a company's windfall tax liability is determined pursuant to a method of valuing property that is familiar to U.S. tax law. Under U.S. tax law, it is common to calculate the value of property by taking into account the property's ability to generate income. That method of calculation does not make a tax imposed on the value of property an income tax.

The fatal flaw in petitioner's position is the premise that every tax calculated using net profits as a variable is "in substance" an income tax. A mathematical relationship between a company's profitability and the amount of the tax imposed does not transform a tax on value into an income tax for purposes of 26 U.S.C. 901. Nor is a foreign tax "in substance" an income tax simply because it can be expected to leave the taxpayer with some net gain. That broad view of the concept of an income tax would greatly expand the universe of foreign taxes that would be eligible for a dollar-for-dollar tax credit under Section 901.

A foreign tax is an income tax if and only if it satisfies the requirements set forth in 26 C.F.R. 1.901-2(b)(2)-(4), and the U.K. windfall tax fails all three of those requirements. Nothing in either the 'egislative history of the windfall tax or the policies behind the U.S. foreign tax credit can transform the windfall tax into taxation of income. The windfall tax therefore is not creditable under Section 901.

A. The Windfall Tax Is A Tax On Value

1. Under U.S. tax principles, it is common for the value of property to be determined based on the property's ability to generate income

a. In the context of federal and state taxes imposed on the value of property, it is common for value to be determined based on the property's ability to generate income. For example, in the federal estate and gift tax contexts, the taxable value of property normally is its fair market value. See 26 U.S.C. 2031(a), 2512; 26 C.F.R. 20.2031-1(b), 25.2512-1. That value generally is determined according to one (or a combination) of three widely recognized valuation methods: the income approach, the market approach, and the asset-based approach. David Laro & Shannon P. Pratt, *Business Valuation and Federal Taxes: Procedure, Law, and Perspective* 12 (2d ed. 2011); see John A. Bogdanski, *Federal Tax Valuation* ¶ 3.01, at 3-2 (2003). The income generated by the property plays an essential role in determining value under both the income approach and the market approach.

Under the income approach, the value of an asset is calculated by determining the present value of the stream of future income that the property is projected to produce. "Capitalization of the stream of economic benefits generated by an asset is in a sense the purest form of valuation that exists." Bogdanski ¶ 3.05[1][b], at 3-51. "As Learned Hand once remarked in a nontax valuation case, 'every one knows that the value of shares in a commercial or manufacturing company depends chiefly on what they will earn.'" *Id.* ¶ 3.05[2], at 3-54 (quoting *Borg* v. *International Silver Co.*, 11 F.2d 147, 152 (2d Cir. 1925)). There are two basic methods for applying the income approach: (1) all expected future

economic benefits are projected and then discounted to present value (discounting), or (2) a single economic benefit is divided by a capitalization rate to yield a present value (capitalizing). Laro & Pratt 164.

Under the market approach, the value of property is determined by identifying comparable property and deriving a valuation multiple from the relevant data. That multiple is then applied to the subject property's data to yield a value for the property. "The most familiar market value multiple," and one of the most commonly used, is "the price/earnings (P/E) multiple." Shannon P. Pratt, *The Market Approach to Valuing Businesses* 4, 10 (2d ed. 2005) (emphasis omitted). As one valuation treatise explains,

> one frequently encounters valuations that look to the ratio of the stock price of the comparable company to its annual earnings, known as the price-earnings ratio for short. This ratio is then applied to the earnings of the company at issue to arrive at a fair market value for all of its stock.

Bogdanski ¶ 3.04[2][b], at 3-29.

b. Consistent with these valuation principles, the Treasury regulations governing estate and gift tax valuation emphasize the importance of income in determining taxable value. They require business interests to be valued based on, *inter alia*, "demonstrated earning capacity of the business." 26 C.F.R. 20.2031-3(b), 25.2512-3(a)(2). Stock that cannot be valued based on selling price must be valued based on "the company's net worth, prospective earning power and dividend-paying capacity." 26 C.F.R. 20.2031-2(f)(2), 25.2512-2(f)(2). Revenue Ruling 59-60, which sets forth guidelines for valuing stock in closely held corporations for estate and gift tax purposes, further states that

"[p]otential future income is a major factor in many valuations of closely-held stocks," and that an appraiser should "accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public." Rev. Rul. 59-60 §§ 4.02(f) and 5(a), 1959-1 C.B. 237, 241, 242.

Under the federal estate tax, 26 U.S.C. 2032A, an executor may elect to value real property used in farming or in a closely held trade or business based on its current operating use, rather than on its generally higher fair market value. This is known as the "special use valuation." Under that valuation method, the value of a farm is computed by taking the "average annual gross cash rental for comparable land," subtracting the "average annual State and local real estate taxes for such comparable land," and dividing that total by "the average annual effective interest rate for all new Federal Land Bank loans." 26 U.S.C. 2032A(e)(7)(A). Because dividing by the interest rate has the same effect as applying a multiplier (*e.g.*, $100 \div .05 = 100 \times 20$), the special use valuation formula computes taxable value as a multiple of average annual rent. Each average annual computation required under the formula is made on the basis of historical data, specifically, "the [five] most recent calendar years ending before the date of the decedent's death." *Ibid.*

c. In the context of state property taxes, it is likewise common for taxable property value to be determined based on the property's ability to generate income. 2 *Bender's State Taxation: Principles and Practice* § 20.05, at 20-29 (Charles W. Swenson ed. 2012). Although assessors generally have discretion to select the most appropriate valuation method under the circumstances, some States have enacted laws directing

use of the income approach in certain circumstances. See, *e.g.*, Colo. Rev. Stat. § 39-1-103(5)(a) (2012) ("The actual value of agricultural lands, exclusive of building improvements thereon, shall be determined by consideration of the earning or productive capacity of such lands during a reasonable period of time, capitalized at a rate of thirteen percent."); Kan. Stat. Ann. § 79-503a(g) (Supp. 2010) (factors to be used in determining property value include "earning capacity as indicated by lease price, by capitalization of net income or by absorption or sell-out period"); Wis. Stat. Ann. § 70.32(2r) (West Supp. 2012) (for property-tax purposes, "[a]gricultural land shall be assessed according to the income that could be generated from its rental for agricultural use"); Mont. Admin. R. 42.20.107(1) (2012) ("income approach valuation" used to determine "market value of commercial properties" for property-tax purposes); Ohio Admin. Code 5703-25-07(D)(2) (2010) (for public utility property tax, "income approach should be used for any type of property where rental income or income attributed to the real property is a major factor in determining value"); see also New York City Dep't of Fin., *Property: Estimating Market Value*, http://www.nyc.gov/html/dof/property/property_val_estimate.shtml (last visited Jan. 10, 2013) (in the case of commercial property and residential properties that contain 11 or more units, New York City Department of Finance "estimates [] property value based on its income producing potential," by "either divid[ing] the net income by a capitalization rate (an estimated rate of return) or [] multiply[ing] the gross income by a multiplier").

It is thus a well-understood U.S. tax principle that income may be an essential variable in calculating the value of property. Under the income approach and the

market approach, actual or projected profits for a particular property are divided by a capitalization rate or multiplied by a price-to-earnings ratio to determine a property value. Consideration of income in this sense does not change the fact that the tax is on the value of the property, not the income.

2. The windfall tax is computed using a formula that is well-understood as a method of valuing property

a. Under the U.K. Act, a company's windfall is calculated using the market approach described above. To calculate a company's windfall-tax liability, a "value in profit-making terms" is imputed to the company by multiplying its "average annual profit" during its initial period by a price-to-earnings ratio of 9. U.K. Act Sch. 1, para. 2(1), (3) (Pet. App. 139); J.A. 129. That figure represents the lowest average price-to-earnings ratio, during the relevant period, of the 32 companies that would be subject to the tax. J.A. 135. As the Commissioner's expert in valuation methodology testified, that formula for determining profit-making value, which is calculated as a multiple of "average annual profit" during the company's initial period, is identical to the market approach for valuing property for tax purposes. J.A. 520-522.

After a company's imputed profit-making value is calculated using the market approach, the company's flotation value (which is calculated by reference to its stock price—another accepted method of valuing property) is subtracted from the imputed value. The resulting "windfall" amount reflects the difference between the price at which a company should have been sold at flotation and the price at which it was actually sold, *i.e.*, the undervaluation of the company at the time of flotation. Finally, a 23% tax is imposed on that "windfall"

amount. See U.K. Act Sch. 1, para. 3 (Pet. App. 139-140). The windfall tax thus is calculated using accepted valuation methods that are familiar in U.S. tax law. It is a tax on value both in form and in substance, not a tax on income.

b. Petitioner contends that the windfall tax is not directed at "'value' in any normal or U.S. sense of the word" (Br. 41-42) because the formula uses a company's past profits, rather than a projection of its future earnings, to determine its profit-making value. As explained above (see pp. 17-18, *supra*), however, the use of past profits to calculate the present value of property is a familiar practice under U.S. tax law. See, *e.g.*, 26 U.S.C. 2032A(e)(7)(A) (calculating average annual rent for special use valuation of farms using data from "the [five] most recent calendar years ending before the date of the decedent's death").

When it enacted the windfall tax in 1997, moreover, Parliament was not attempting to determine the value of the privatized companies as of that date. It sought instead to devise a formula that would properly value the companies as of the date their stock was sold to the public, which for SWEB was December 1990. In 1997, Parliament did not need to project SWEB's future earnings for the four-year initial period following its 1990 flotation; those profits were known. Parliament's reliance on historical profits therefore does not alter the fact that, in the windfall tax statute, Parliament used an established valuation method to determine the value of each privatized company as of the time of flotation.

c. Petitioner further contends (Br. 42) that the windfall tax formula is not an earnest attempt to value a company because it "ignores a readily available measure of value in the form of the publicly traded price of the

companies' stock." *Ibid.* But because Parliament was attempting to value the companies as of the date of flotation, the price of the companies' stock as of some later date would have been an inadequate proxy. Particularly where, as here, the statutory formula comports with well-established valuation principles, the fact that a different—and in this case less accurate—valuation method might have been used does not cast doubt on the basic character of the U.K. windfall tax as a tax on company value.

The Parliamentary debate on the windfall tax identifies several reasons why Parliament chose the valuation formula it did. In defending the formula, which some members of Parliament criticized as simplistic and unfair, Geoffrey Robinson stated that "simplicity has great merits," including reducing the opportunities for tax avoidance and valuation disputes. J.A. 172, C.A. J.A. 460; see J.A. 158 (statement of Parliament member Ross Cranston that the "Government have rightly taken the approach of a simple formula, as set out in the schedule" because "[a]ny other approach would open opportunities for [tax] avoidance"). Robinson also repeatedly defended the price-to-earnings ratio of 9, stating that "setting the price-to-earnings ratio at nine, slightly below the lowest sectoral average[,] shows a Government who are trying to be reasonable and fair in all respects." J.A. 164; see J.A. 153. The windfall tax is thus a tax on value both in substance and in form. It is calculated according to established valuation methods that are familiar to U.S. tax law.

In any event, for purposes of the Section 901 inquiry, it is irrelevant whether Parliament employed the soundest available method of valuing the privatized companies. If the windfall tax was in fact a tax on an incre-

ment of company value, it is not creditable. The text of the U.K. Act states unambiguously that the privatized companies' profits were used, not as the base of the windfall tax, but as one determinant of company value. See U.K. Act Sch. 1, paras. 1-2 (Pet. App. 138-139).

B. The Windfall Tax Is Not "In Substance" An Income Tax

The windfall tax takes into account a company's profits during its four-year initial period to assess the profit-making value of that company as of the date of flotation. Use of company profits as one variable in the statutory formula does not make the windfall tax an income tax. Petitioner's "substance-over-form" argument reflects the premise that, if a tax is calculated using profits as a variable, it necessarily is "in substance" a tax on income. That premise is unsound.

1. A tax that is calculated using profits as a variable is not necessarily "in substance" an income tax

a. As petitioner emphasizes (Br. 9-10, 37-50), the statutory formula used to calculate the U.K. windfall tax can be re-expressed as approximately 51.75% of the difference between (1) a company's profits during its four-year initial period and (2) 4/9 of its flotation value. Petitioner contends on that basis that the windfall tax is properly viewed as a 51.75% tax on each company's "excess profits." Those mathematical calculations do not show that the windfall tax is "in substance" an income tax.

Whenever the value of taxed property is calculated by reference to the income that the property has produced or is expected to produce, and the tax in turn is a specified percentage of the property's value, the amount of the tax can always be expressed as a percentage of actual or expected income. If that mathematical rela-

tionship were sufficient by itself to render the tax an income tax, the distinction between a tax on income and a tax on value would be largely eviscerated. This Court has long recognized that "[t]he incidence of a tax on income differs from that of a tax on property." *New York ex rel. Cohn* v. *Graves*, 300 U.S. 308, 314 (1937). That principle holds true even when the formula used to calculate value includes actual or projected income as one variable.

b. Petitioner is also wrong in contending (Br. 9) that "profits are the only variable in the [windfall tax] equation." *Ibid.* Each company's taxable windfall amount is calculated by subtracting its actual flotation value from its assessed profit-making value. Because the flotation value is a separate variable that is different for each company, two companies with the same initial-period profits may face substantially different windfall-tax liability because one was sold to the public at a higher price. Indeed, at least one privatized utility (British Energy plc) paid no windfall tax at all, even though it realized a profit during its initial period, because its flotation value was higher than its profit-making value as determined under the statutory formula. See Appellee's R.E. at Tab H, sch. 4B, *Entergy Corp.* v. *Commissioner*, 683 F.3d 233 (5th Cir. 2012) (No. 10-60988), petition for cert. pending, No. 12-277 (filed Sept. 4, 2012).

It is therefore wrong, or at least potentially misleading, to describe the U.K. Act as providing that "[t]he more profitable the company was during [the four-year initial period], the higher the tax." Pet. Br. 8. To be sure, for any particular privatized company, flotation value is a fixed historical fact that will not change depending on the company's subsequent operation. Once a particular company's flotation value has been estab-

lished and can be treated as a constant, plugging higher initial-period profit figures into the statutory formula will indeed produce higher windfall-tax liability.[2] It does not follow, however, that tax liability under the U.K. Act depends only on profitability, or that more profitable privatized companies will necessarily pay more tax than will less profitable businesses. Rather, the sum that the U.K. government received for a company at flotation is an equally important determinant of the amount (if any) of windfall tax that the company owes.

c. The use of flotation value as a variable in the statutory formula also is not typical of excess-profits taxes. See Entergy Corp. & Affiliated Subsidiaries Amicus Br. (Entergy Amicus Br.) 3-6; Am. Elec. Power Co. Amicus Br. (AEP Amicus Br.) 6-7. In 1917, Congress enacted an excess-profits tax that was imposed at the rate of 8% of a taxpayer's net income exceeding the sum of $5000 and 8% of its "actual capital invested." See Act of Mar. 3, 1917, ch. 159, Tit. II., 39 Stat. 1000. The "invested capital" standard is based on the assumption that "normal" profits are measured by a return on capital invested in the business.

Congress also enacted excess-profits taxes around the time of World War II and the Korean War. Under the Excess Profits Tax Act of 1940, ch. 757, Tit. II, 54 Stat. 975, a tax was imposed on the taxpayer's net income over an allowance. To calculate the allowance, a taxpayer could choose between an "invested capital" method and a "base period" method. Under the "base period" method, the allowance was based on the taxpayer's average profits during a set base period of 1936-1939; profits above that average profit were taxed. The

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[2] That is why SWEB's downward adjustment to its financial statements reduced its windfall-tax liability. See Pet. Br. 38.

Korean War excess-profits tax was calculated in a similar way. See Excess Profits Tax Act of 1950, ch. 1199, Tit. I, 64 Stat. 1137. Within the United States, excess-profits taxes thus have historically been imposed on a base of net income over a floor, with the floor being determined by either historical net income during a base period, or a specified percentage of return on the company's capital investment.

Amicus Entergy contends that, in the U.K. windfall tax, "[a] percentage return on flotation value served the function of an invested capital standard." Entergy Amicus Br. 25; see AEP Amicus Br. 14 ("[T]he flotation value was used to determine what portion of the profits were considered 'normal.'"). Under the formula established by the U.K. Act, however, a company could make far higher initial-period profits than it did during any historical base period and pay no windfall tax, so long as the U.K. government was properly compensated for the value of the company at flotation. The U.K. Act requires that initial-period profits be compared, not to any measure of "normal" profits, but to the value that was placed on the company when it was sold. That difference between the windfall tax and historic excess-profits taxes reinforces the conclusion that the windfall tax is a tax on value.

d. Petitioner's theory of the case largely centers on its effort to demonstrate the mathematical equivalence of two potential formulas for computing the windfall tax. The first is the following:

$$\text{Windfall Tax} = 23\% \times (((365 \times P/D) \times 9) - FV)$$

See Pet. App. 4. The second is petitioner's proposed rewrite:

$$\text{Windfall Tax} = 51.75\% \times (P - (4/9 \times FV))$$

See Pet. Br. 10.

For purposes of computing a particular privatized company's windfall-tax liability, those formulas are indeed equivalent. Assuming that 1461 (four years including a leap day) is used as the value for D, both formulas will produce essentially the same number for tax owed when the same values for P (initial-period profits) and FV (flotation value) are used in the two equations. For purposes of identifying the applicable tax rate and the base on which the windfall tax is imposed, however, the two formulas have very different implications. The first formula uses profits as one determinant of company value and taxes an increment of value at a rate of 23%. The second treats income as the tax base, and it imposes a tax of 51.75% on an increment of initial-period profits above a floor set at four-ninths of flotation value. Although the two formulas produce the same tax liability if P and FV are held constant, that is just a matter of algebra. It is the choice between the two that determines whether the windfall tax is properly viewed as a tax *on* income. And there is no question which of the two formulas Parliament actually enacted.

It bears emphasis, in this regard, that the question before this Court has nothing to do with the *propriety* of Parliament's action. Congress obviously could not, and in enacting Section 901 did not purport to, limit the authority of any foreign government to enact any type of tax. The question here is not whether the U.K. government could impose and collect the tax, but whether certain costs incurred as a result of the U.K. Act should be borne by petitioner or instead by the U.S. Treasury. Petitioner's insinuations that Parliament used a subterfuge to obscure what was in substance an income tax are

therefore particularly misplaced in this context. Although the application of Section 901 does not turn on the label that a foreign government attaches to its tax, United States courts should accept the relevant foreign law's designation of the applicable tax rate and the base on which the tax is imposed. Under that approach, the U.K. Act did not impose an income tax.

In any event, there is no sound reason to doubt that the formula used in the U.K. Act accurately reflects Parliament's reasons for imposing the windfall tax. The companies subject to the tax had previously been owned by the U.K. government, and the government was believed to have sold the companies at too low a price. The windfall tax is an attempt to recover some of that lost value. Whether that effort was a wise exercise of Parliament's authority (cf. Pet. Br. 6, 7) is not relevant to the issue before this Court. What matters is whether the windfall tax is taxation of income as that concept is understood in the United States. It is not.

2. A tax on value that is not confiscatory of net gain is not necessarily "in substance" an income tax

Petitioner also relies (Br. 26-31) on case law that predates the 1983 Treasury regulation. Petitioner describes those decisions as holding that a foreign tax is creditable under Section 901 so long as the tax "is likely to reach net gain." Pet. Br. 31. All of those decisions, however, involved foreign statutes that specifically identified gross income as the base on which the tax was levied.

As a general matter, a gross-income tax is not similar in concept to an "income tax" in the U.S. sense. That is because the U.S. income tax is imposed only on those taxpayers who have a net gain after deducting from gross income the costs and expenses incurred to produce

that income. See *Eisner* v. *Macomber*, 252 U.S. 189, 207-208 (1920). In the decisions on which petitioner relies, the courts concluded that a foreign gross-income tax may bear a sufficient resemblance to the U.S. income tax, thereby allowing the taxpayer to qualify for a tax credit under Section 901, if the tax would almost certainly reach net gain in the normal circumstances in which it applies.

The decisions petitioner cites do not suggest that *every* foreign tax that is likely to reach a taxpayer's net gain—even a tax on the value of property—is eligible for a dollar-for-dollar tax credit under 26 U.S.C. 901. To the contrary, those decisions describe an income tax as a tax on gain or profits and explain that "[t]axes plainly on subjects other than income, even though measured to some extent by income, are not income taxes." *Inland Steel Co.* v. *United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) (per curiam).

a. *Seatrain Lines, Inc.* v. *Commissioner*, 46 B.T.A. 1076 (1942), involved a 3% tax imposed by the Cuban government on "money received by foreign shipping companies for cargoes and passengers taken aboard in Cuban ports." *Id.* at 1077. The Board of Tax Appeals explained that the tax had formerly been a 6% tax on net profits, but had been adjusted to a 3% tax on gross income because of "controversy [that] arose between the shipping companies and the tax authorities * * * on the question of what proportion of expenses should be allowed against revenues * * * in determining 'net profits.'" *Ibid.* The Board explained that the reduction in the tax rate had been "adopted as a compromise measure in order to avoid the complex and vexatious allocation and calculation of the deductible items peculiar to the [taxpayer's] business," and that the tax clearly

"took [the] place" of the former 6% tax on net profits under Cuban tax law, thus preserving its character as an income tax. *Id.* at 1080-1081.

In *Bank of America National Trust & Savings Ass'n* v. *United States*, 459 F.2d 513, cert. denied, 409 U.S. 949 (1972) (*Bank of America I*), the Court of Claims evaluated three foreign taxes that "were all in substance levies on the taxpayer's gross income from its banking business carried on by its branch in the particular country." *Id.* at 516-517. The court explained that "[f]or none of the three taxes was the taxpayer permitted to deduct from gross income the costs or expenses of its banking business or of producing its net income," which was problematic because "gain is a necessary ingredient of income." *Id.* at 517. The court concluded that "[i]n certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income," which would be the case if it were clear that the costs, expenses, and losses incurred in making that gain were less than gross income. *Id.* at 519. The court held that "a direct income tax is creditable, even though imposed on gross income, if it is very highly likely * * * always to reach some net gain in the normal circumstances in which it applies." *Id.* at 519-520. The court concluded, however, that the foreign taxes at issue were not creditable because they were levied on gross income with no allowance for deductions of costs and expenses, and that "[a]ny taxpayer could be liable whether or not it operated at a profit during the year." *Id.* at 524.

In *Bank of America National Trust & Savings Ass'n* v. *Commissioner*, 61 T.C. 752 (1974), aff'd, 538 F.2d 334 (9th Cir. 1976) (Table) (*Bank of America II*), the Tax Court evaluated the same foreign taxes and agreed with the Court of Claims' holding that Section 901(b)(1) "in-

cludes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit." *Id.* at 760 (quoting *Bank of America I*, 459 F.2d at 523).

Finally, in *Inland Steel*, the Court of Claims evaluated whether the taxpayer was entitled to a foreign tax credit for the Ontario Mining Tax, which was imposed on sale proceeds of iron. 677 F.3d at 79. The court concluded that the tax was not an income tax because it did not allow "significant costs of the mining business" to be deducted, and it was imposed on an "artificial computation of net profit" that would not "be recognized as such in this country." *Id.* at 84-85.

b. None of those pre-regulation foreign-tax-credit cases suggests that every foreign tax can be considered taxation of income so long as it can be expected to reach net gain. In all of those cases, the base of the foreign tax was gross income, and the courts described the U.S. concept of an income tax as "*a direct tax on gain or profits*." *Bank of America II*, 61 T.C. at 760 (emphasis added) (quoting *Bank of America I*, 459 F.2d at 523); see *Bank of America I*, 459 F.2d at 517, 519-520 (stating that "an income tax is a direct tax on gain or profits" and holding that "*a direct income tax* is creditable, even though imposed on gross income, if it is very likely to reach some net gain in the normal circumstances in which it applies") (emphasis added); *Keasbey & Mattison Co.* v. *Rothensies*, 133 F.2d 894, 897 (3d Cir.) ("[A]n income tax is a direct tax upon income."), cert. denied, 320 U.S. 739 (1943); see also *Allstate Ins. Co.* v. *United States*, 419 F.2d 409, 414 (Ct. Cl. 1969) (same).

In particular, none of the pre-regulation decisions suggests that a court, in applying Section 901, can adopt

an understanding of the applicable tax base different from that specified in the relevant foreign law. It is one thing to say that a foreign tax on gross income can operate "in substance" as an "income tax in the U.S. sense," even though the relevant foreign law does not allow deductions for incurred expenses. It is quite another to say that a foreign tax imposed by its terms on an increment of property value can be reconceptualized, through offsetting alterations to the statutory tax base and tax rate, as a tax on income. The decisions on which petitioner relies do not support that proposition.

c. Petitioner may be correct that "none of the 31 companies that paid the windfall tax had a windfall tax liability in excess of its total profits over its initial period." Pet. Br. 45 (quoting Pet. App. 79). But if that were a sufficient basis for treating the tax as creditable under 26 U.S.C. 901, a variety of taxes that are indisputably computed using criteria other than income (*e.g.*, a tax on the value of property) would trigger a dollar-for-dollar credit so long as the amount of the tax was unlikely to exceed the taxpayer's net gain. The foreign tax credit is an exemption from taxation that must be narrowly construed, *Texasgulf, Inc.* v. *Commissioner*, 172 F.3d 209, 214 (2d Cir. 1999); *Keasbey & Mattison*, 133 F.2d at 898, and it applies only to "income, war profits, and excess profits taxes," 26 U.S.C. 901(b)(1). Although a comparison between the amount of a tax and the taxpayer's net gain may bear on whether a *gross*-income tax is "an income tax in the U.S. sense," 26 C.F.R. 1.901-2(a)(1)(ii), such a comparison is not a stand-alone test for creditability.

C. The Windfall Tax Does Not Satisfy Any Of The Three Regulatory Tests Set Forth In 26 C.F.R. 1.901-2(b)(2)-(4)

The 1983 Treasury regulation defines a creditable "income, war profits, or excess profits" tax for purposes of 26 U.S.C. 901. See 26 C.F.R. 1.901-2. The agency promulgated the regulation to bring structure and clarity to the inquiry used to determine whether particular foreign taxes are creditable under Section 901. The regulation adopts the "net gain" standard that had emerged in the case law, but it lays out specific criteria required to meet that standard.

As the preamble to the regulation explains,

> [u]nder these final regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies. This standard, found in § 1.901-2(a)(3)(i), adopts the criterion for creditability set forth in *Inland Steel Company* v. *U.S.*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America National Trust and Savings Association* v. *U.S.*, 459 F.2d 513 (Ct. Cl. 1972), and *Bank of America National Trust and Savings Association* v. *Commissioner*, 61 T.C. 752 (1974). The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

T.D. 7918, 1983-2 C.B. 113, 114. Thus, "[a]lthough § 1.901-2's preamble reaffirms *Inland Steel*'s general focus upon the extent to which a tax reaches net gain, both the preamble and § 1.901-2 introduce three detailed tests for conducting the net gain inquiry." *Texasgulf,*

Inc., 172 F.3d at 216; see Pet. App. 6-7 n.1 (court of appeals stating that the regulation does not adopt a "'predominant character standard' [that is] independent of the three requirements," and that under the regulation, a court "may not * * * simply ask whether the 'predominant character' of a foreign tax is that of a U.S. income tax without addressing the [three regulatory] requirements").

Under the regulation, a foreign tax triggers the dollar-for-dollar credit "*if and only if* the tax, judged on the basis of its predominant character," satisfies each of three tests: the realization test, the gross-receipts test, and the net-income test. 26 C.F.R. 1.901-2(b)(1) (emphasis added). That regulation has the force of law, see *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704 (2011), and petitioner has conceded that "[t]here is no dispute regarding the validity of the [r]egulation," Pet. C.A. Br. 39 n.15. Because the U.K. windfall tax does not satisfy any of those three regulatory requirements, it is not an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901.

1. The windfall tax does not satisfy the realization test

A foreign tax satisfies the realization test if "it is imposed * * * [u]pon or subsequent to the occurrence of events ('realization events') that would result in the realization of income under the income tax provisions of the Internal Revenue Code." 26 C.F.R. 1.901-2(b)(2)(i)(A). By its terms, the U.K. windfall tax was imposed upon a deemed "windfall" amount that reflected the company's undervaluation at the time of flotation, *i.e.*, the difference between the price at which the company was sold at flotation and the price at which it should have been sold. The relevant event upon which the windfall tax was imposed is thus the flotation of a

company at too low a value, which for SWEB occurred in 1990.

The U.K. government's sale of SWEB's stock to the public during the flotation process was not a realization event to SWEB, because SWEB was not a party to that sale. See J.A. 63-69. Instead, the flotation process merely changed the identity of SWEB's shareholders. And even if the company had directly sold its stock to the public, it would not have realized income as a result. A corporation's raising of capital through an original issuance of stock is not an event "that would result in the realization of income under the income tax provisions of the Internal Revenue Code." 26 C.F.R. 1.901-2(b)(2)(i)(A); see 26 U.S.C. 1032; *General Electric Co.* v. *United States*, 299 F.2d 942, 945-947 (Ct. Cl.), cert. denied, 371 U.S. 940 (1962).

As we explain above (see pp. 23-28, *supra*), although the U.K. Act's formula for computing profit-making value used initial-period profits as one variable, Parliament's objective was to value the companies as of the date of flotation. The "windfall" that Parliament chose to tax thus was the undervaluation of the companies at flotation, not a perceived appreciation in value during the four years thereafter. But even if the relevant windfall were thought to be an increase in SWEB's value during the company's initial period, the U.K. windfall tax would not satisfy the realization test. Although economists may consider appreciation in value of property held by a taxpayer (such as stock or real property) to be income, appreciation is not generally subject to tax under U.S. tax principles. See *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554, 559 (1991); *Weiss* v. *Weiner*, 279 U.S. 333, 335 (1929). Rather, the Internal Revenue Code taxes gain from property when the gain

has been realized through a sale or other disposition of the property. 26 U.S.C. 1001; *Cottage Sav. Ass'n*, 499 U.S. at 559.

The formula used to calculate the windfall tax "did not ensure that the companies had actually realized the amount being taxed." Pet. App. 14 n.3. To the contrary, for 23 of the 31 companies that had a windfall-tax liability, the base on which the windfall tax was imposed exceeded the realized initial-period profits. See Appellee's R.E. at Tab H, sch. 4B, *Entergy Corp.*, *supra* (No. 10-60988). Of the 12 electric companies that paid the tax, ten companies—including SWEB—had taxable "windfalls" that were roughly £100 million greater than their total initial-period profits. J.A. 195. SWEB's total profits for its initial period were £306.2 million, but its taxable windfall (*i.e.*, the difference between its imputed profit-making value and its flotation value) was £393.1 million. *Ibid.* That disparity highlights the fact that the windfall tax was not imposed on past realized gain.

2. The windfall tax does not satisfy the gross-receipts test

Under the Treasury regulation, "[a] foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of * * * [g]ross receipts; or * * * [g]ross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." 26 C.F.R. 1.901-2(b)(3)(i). Although a company's profit-making value under the U.K. Act depends on its average annual profit during the initial period, which involves computation of gross receipts during that period, the windfall tax was not imposed on the basis of those gross receipts. In the windfall-tax formula, the average annual profit of the company is multiplied by 9 to yield a

profit-making value, and the tax is imposed on the difference between that value and the company's flotation value. That tax base therefore is a company value that is divorced from the traditional concept of gross receipts.

Petitioner criticizes (Br. 42-48) the court of appeals' reliance on Example 3 illustrating the regulation's gross-receipts test. That Example discusses the application of the gross-receipts requirement to a foreign tax on the extraction of petroleum that "deems" a company's gross receipts from extraction to be 105% of the fair market value of the petroleum extracted. See 26 C.F.R. 1.901-2(b)(3)(i)(A), Ex. 3. Example 3 explains that such a foreign tax would not meet the gross-receipts requirement because "[t]his computation is designed to produce an amount that is greater than the fair market value of actual gross receipts." *Ibid.*

Although the example is not directly applicable because it analyzes imputed gross receipts rather than actual gross receipts, it provides a useful analogy. The U.K. windfall tax computes a company's annual average profit using its actual gross receipts, but that average is multiplied by a price-to-earnings ratio of 9 to yield a company's profit-making value. A company's profit-making value thus had no apparent relation to gross receipts and may well have exceeded gross receipts during the initial period. As the court of appeals explained, a tax imposed on an amount in excess of the fair market value of gross receipts fails the gross-receipts test. Pet. App. 12-14.

Petitioner seeks to avoid that conclusion by recharacterizing the U.K. windfall tax as a tax of 51.75% on any initial-period profits in excess of 4/9 of a company's flotation value. Pet. Br. 10. But as the court of

appeals further recognized, Example 3 assumes that the tax base specified in the relevant foreign law is to be taken as given. "[A] 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts, the latter of which would satisfy the gross receipts requirement." Pet. App. 13. Example 3 would make no sense, however, if a U.S. taxpayer could render the hypothetical 20% tax creditable simply by recharacterizing it as a 21% tax on a lower tax base. See *id.* at 13-14.

Petitioner also points out (Br. 46) that, under the regulation, "[a] foreign tax that, judged on the basis of its predominant character, is imposed on the basis of [gross receipts] satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph." 26 C.F.R. 1.901-2(b)(3)(i) (flush language). That language merely allows a foreign tax with minor non-conforming elements, such as inclusion of unrealized rental income (which amounts are not "gross receipts") in the tax base, to meet the gross-receipts test based on its "predominant character." See 26 C.F.R. 1.901-2(b)(2)(i) (flush language). It does not mean that a foreign tax satisfies the gross-receipts test so long as "gross receipts" is one variable in the tax formula.

3. The windfall tax does not satisfy the net-income test

a. The net-income test is satisfied if "the base of the tax is computed by reducing gross receipts * * * to permit * * * [r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." 26 C.F.R. 1.901-2(b)(4)(i)(A). The "base" of the U.K. windfall tax is not computed in that way. Rather, as explained above, the base of the tax is computed

by assessing a company's value using average annual profit and a price-to-earnings multiple, then subtracting its flotation value. A 23% tax rate is applied to that base.

For 23 of 31 companies that paid the windfall tax, including SWEB, the company's windfall amount subject to tax was an amount *greater* than its net profits during the initial period. J.A. 195; see p. 36, *supra*. As the court of appeals correctly recognized, those data show that the base on which the tax was imposed was neither a company's net income nor a subset of net income (such as net income above a specified amount). Pet. App. 14 n.3.[3] The data thus refute the contention of amicus Entergy that "the amount produced as the tax base by the Windfall tax formula is, in every case, a subset of gross receipts less operating expenses." Entergy Amicus Br. 18 (emphasis and internal quotation marks omitted). In

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[3] Petitioner contends (Br. 48-49) that the court of appeals "veered even further off course when it suggested that the U.K. windfall tax is not creditable because it was imposed on a *subset* of initial period profits, rather than on *total* period profits." *Id.* at 48. The court of appeals said no such thing, and petitioner's citation to footnote 2 of the court of appeals' opinion does not support its characterization. See Pet. App. 10-11 n.2. In footnote 2, the Third Circuit simply addressed and rejected petitioner's argument that 26 C.F.R. 1.901-2 provides no guidance on what constitutes a creditable excess-profits tax. See Pet. C.A. Br. 36. The court pointed out that the same three-part test applicable to income taxes (realization, gross-receipts, net-income) applies to excess-profits taxes, and it noted that petitioner had not challenged the validity of the regulation for failing to set forth a different test for excess-profits taxes. In any event, the court recognized that if the windfall tax were an excess-profits tax, then it presumably would have been imposed on a subset of the companies' total profits. It rejected that characterization because "the [windfall] amount being taxed [] was greater than initial-period profit." Pet. App. 14 n.3.

fact, the tax base was the difference between the price at which a company was sold (as computed based on the statutory formula for assessing profit-making value) and the price at which it should have been sold. For most companies subject to the tax, that difference was greater than the company's total profits during its initial period.

b. Although petitioner does not directly address the net-income test, it contends that a foreign tax may be creditable "even if the base of that tax does not consist of net gain in the U.S. sense." Pet. Br. 45. The net-income test requires, however, that "the base of the tax [must be] computed by reducing gross receipts * * * to permit * * * recovery of significant costs and expenses." 26 C.F.R. 1.901-2(b)(4)(i)(A). Petitioner's argument that "what matters is whether a tax 'is likely to *reach* net gain,' not the base on which it is imposed," Pet. Br. 45 (citation omitted), flatly ignores the Treasury regulation.

c. Petitioner contends (Br. 45) that, under the regulation, a tax "that is unambiguously imposed on something greater than net gain, such as gross receipts," may still be creditable if "'the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain' remaining." *Ibid.* (quoting 26 C.F.R. 1.901-2(b)(4) (flush language)). The flush language petitioner quotes is less permissive than petitioner suggests. That language provides:

> A foreign tax *whose base is gross receipts or gross income* does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross re-

> ceipts or gross income, respectively, and the tax rate is such that after the tax is paid persons subject to the tax are almost certain to have net gain.

26 C.F.R. 1.901-2(b)(4) (flush language) (emphasis added). That language establishes that, in rare circumstances, a foreign tax "whose base is gross receipts or gross income" may satisfy the net-income requirement even though the taxpayer's costs and expenses are not deducted in determining the tax base. The limited nature of that exception is consistent with pre-regulation case law. See pp. 29-32, *supra*. Where (as here) the base of a foreign tax is *neither* net nor gross income, the regulation does not allow the foreign tax to be characterized as an income tax simply because it can be expected to leave the taxpayer with some net gain.

d. That the regulation requires the base of a foreign tax to be net income does not mean that the Commissioner's position turns on "labels" and "form." As petitioner correctly observes (Br. 33-35), the regulation calls for "scratching" beneath the surface of the foreign statute in certain aspects to account for non-income-tax-like elements of the foreign tax base and otherwise to look for essential equivalence with U.S. income-tax features. See, *e.g.*, 26 C.F.R. 1.901-2(b)(4)(i) (flush language) (stating that for net-income test, "[a] foreign tax law that does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses"); see also 26 C.F.R. 1.901-2(b)(2)(i) (flush language) (stating that realization test may be met "even though the base of [the] tax also includes imputed rental income" as long as it is not "based only or predominantly on such imputed rental income");

26 C.F.R. 1.901-2(b)(3)(ii) (gross-receipts test may be met if approximation thereof is computed under a method not likely to produce an amount exceeding fair market value).

That structured flexibility does not mean, however, that every foreign tax—including a tax on a subject other than income—can be classified as an income tax so long as it will normally reach net gain. The base of the U.S. income tax is gross income minus allowable deductions. The Treasury regulation identifies foreign taxes with a similar base to receive the dollar-for-dollar credit against a taxpayer's U.S. income tax liability that Section 901 allows.

In that respect, the "labels" and "form" that a foreign government uses to formulate a tax are relevant, even if they are not determinative of how the tax should be classified. See, *e.g.*, *Phillips Petroleum Co.* v. *Commissioner*, 104 T.C. 256, 295-296 (1995) ("While labels should not be determinative in the question of creditability, the declaration of the lawmaking power is entitled to much weight."); cf. *United States* v. *Mississippi Chem. Corp.*, 405 U.S. 298 (1972) (in determining the tax consequences of purchasing stock in federally established farm banks, the form of the stock chosen by Congress "must have considerable impact" and "has [a] bearing on the tax consequences of the purchases"). The "base" of the windfall tax could not be described as net income unless both the tax base and the tax rate are rewritten, which is what petitioner has done to characterize the tax as a 51.75% tax on excess profits. There are infinite ways to express the algebraic formula that is the windfall tax, but the classification of the tax should be based on the iteration selected by Parliament. By treating the tax as a formula whose factors can be rearranged at will,

petitioner has stripped the U.K. statute of its core concepts. See pp. 26-27, *supra*.

e. Petitioner suggests (Br. 23, 26) that foreign statutory text cannot form the basis for analysis due to language and conceptual barriers. That argument rings especially hollow in this case, as the U.K. statute is in English, and petitioner's accounting expert testified that British and U.S. accounting principles are "fundamentally the same." J.A. 434. All of the key terms used in the windfall tax are defined in detail in the U.K. statute. As we explain above, moreover, it is well-established as a matter of U.S. tax law that (i) the value of income-producing property can be calculated by reference to actual or projected income, and (ii) a tax on property so valued is not an income tax. If the text of the U.K. Act is taken at face value, the tax is in substance a tax on excess value (*i.e.*, the difference between the actual value of the privatized companies and the amounts the U.K. received for them at flotation) rather than a tax on income as such.

D. The Legislative History Of The U.K. Act Does Not Support Petitioner's Attempt To Characterize The Windfall Tax As An Income Tax

Petitioner contends (Br. 13-14, 39-40) that the legislative history of the U.K. Act reveals the windfall tax to be an excess profits tax "dressed * * * up" as a tax on value for unspecified "'presentational' reasons peculiar to the U.K. political and economic environment at the time." *Id.* at 13 (quoting Pet. App. 58). According to petitioner (Br. 8-9), Parliament created a formula that determined an "artificial" profit-making value for each company by applying an "arbitrary" price-to-earnings ratio of 9, thereby imposing an excess-profits tax disguised as a tax on the difference between two values.

The legislative history of the windfall tax does not bear out that characterization.

In support of its contention that Parliament intended to tax "excess profits," petitioner relies almost entirely on testimony from Arthur Andersen employees. Those employees were not the "drafters of the tax" (Pet. Br. 13), however, but instead were paid consultants of Geoffrey Robinson. J.A. 502. Nor did they coin the phrase "value in profit-making terms." Christopher Wales of the Andersen team testified that, although the team presented its windfall tax proposal to the U.K. Treasury, the Office of Parliamentary Counsel drafted its own legislation, which differed from the Andersen proposal. In particular, Parliamentary Counsel devised the statutory phrase "value in profit-making terms," which was not in the Andersen proposal. J.A. 343-345; C.A. J.A. 1200-1201. And after making its presentation to the U.K. Treasury, the Andersen team had no further involvement in the enactment of the U.K. Act. C.A. J.A. 1209-1213.

Thus, the Andersen team's unsubstantiated testimony that the windfall tax was "dressed up" as a value tax for unspecified political reasons does not establish that Parliament shared that view. And the Andersen team's speculation as to the meaning of "value in profit-making terms" is entitled to no weight. Even if their views were shared by Geoffrey Robinson, a single Member of Parliament, there is no basis for ascribing those views to Parliament as a whole. See *Western Air Lines, Inc.* v. *Board of Equalization*, 480 U.S. 123, 131 n.* (1987) (rejecting affidavit of lawyer involved in legislative process, stating that "[a]ppellants' attempt at the creation of legislative history through the *post hoc* statements of interested onlookers is entitled to no weight"); *Bread*

Political Action Comm. v. *FEC*, 455 U.S. 577, 582 n.3 (1982) (giving no weight to affidavit by Senator's executive assistant, who drafted legislation); see also *Graham Cnty. Soil & Water Conservation Dist.* v. *United States*, 130 S. Ct. 1396, 1409 (2010) (Senator's post-enactment letter was of "scant or no value" in determining legislative intent).

In any event, the record refutes petitioner's claim that the windfall tax was structured as a value tax solely for "presentational" reasons. To the contrary, the perceived undervaluation of the privatized companies was just as much a justification for the tax as the companies' perceived excess profits. Andersen's own proposal to the U.K. Treasury stated that "[t]he structure of the tax should reflect, as closely as possible, the reason for its imposition. As we understand it, these reasons have been identified by the Labour Party as value foregone by the taxpayer as a result of privitisation at too low a price; a regulatory regime that was initially too lax; and the exploitation of an initial degree of monopoly power." C.A. J.A. 236. Britain's Institute of Fiscal Studies, which wrote extensively about the windfall tax, identified the same three reasons for the tax. *Id.* at 779.

In the same budget speech that petitioner cites for Gordon Brown's reference to taxing "excess profits" (Pet. Br. 14), Brown stated that "[i]n determining the details of the tax, I believe I have struck a fair balance between recognising the position of the utilities today and their under-valuation and under regulation at the time of privatisation." J.A. 126. Brown explained that "[a] company's tax bill will be based on the difference between the value that was placed on it at privatisation, and a more realistic market valuation based on its after-tax profits for up to the first [four] full accounting years

following privatisation." *Ibid.* In its explanatory notes accompanying the windfall-tax bill, the U.K. Treasury stated that "[t]he profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation * * * because the companies were sold too cheaply and regulation in the relevant periods was too lax." J.A. 140-141. And in the Parliamentary debate over the windfall tax, Geoffrey Robinson stated that "the rationale of the tax" was that "the companies were sold off too cheaply when their shares were offered under value on flotation, and were regulated too loosely in the initial period after privatisation." J.A. 148.[4]

Parliament's perception thus was *both* that the utilities had been sold too cheaply *and* that their initial-period profits had been excessive. As the Tax Court stated, "both [petitioner and the Commissioner] may be said to be correct in their assessment of the political motivation for the windfall tax." Pet. App. 80. Based on that assessment of the companies' privatization and its aftermath, Parliament might reasonably have chosen *either* to tax the companies' perceived excess profits *or* to impose a tax on some increment of company value. The law that Parliament actually enacted, however,

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[4] The possibility that a U.S. foreign tax credit would not be available to U.S. shareholders of the privatized companies, because the windfall tax was "a tax on capital rather than income," was discussed during the Parliamentary debate. Members of Parliament expressed the view that the windfall tax would *not* be eligible for a tax credit in the United States. J.A. 162, 169-170, 176; see C.A. J.A. 830 (Chartered Institute of Taxation's July 1997 Representations on the Finance Bill) ("Windfall Tax, as structured, does not give rise to a credit of this type because it is not a tax on profits but rather a tax based on the value of the company itself.").

unambiguously identified the base of the tax as the difference between a company's "value in profit-making terms" and the price for which the company was sold. *Id.* at 138-140. And in treating initial-period profits as one determinant of company value, Parliament employed a valuation method that is frequently used for U.S. tax purposes. Thus, while Parliament might have levied a tax on excess profits as such, it instead treated profits as one variable to be used in calculating company value, an increment of which value was the base on which the tax was imposed. Nothing in the U.K. Act's legislative history justifies disregarding that choice.

E. Disallowing A Foreign Tax Credit For Petitioner's Portion Of The Windfall Tax Paid By SWEB Does Not Result In Double Taxation

Petitioner contends (Br. 26-27) that its version of "substance-over-form" is necessary to preserve Congress's policy of mitigating double taxation through 26 U.S.C. 901. But Section 901 operates only to prevent double taxation *of income*, and there was no double taxation of SWEB's income here. SWEB paid U.K. income tax in the same years that it paid the windfall tax (1997 and 1998), and a foreign tax credit was available to petitioner for that income tax. 9/22/11 C.A. Oral Arg. Tr. 33.

This does not mean that foreign taxes other than income taxes are irrelevant to a U.S. taxpayer's obligations under the Internal Revenue Code. Under 26 U.S.C. 164(a)(3), taxpayers may claim a deduction for foreign non-income taxes paid. A taxpayer (like petitioner) that did not directly pay the foreign tax receives the benefit of the deduction through other Internal Revenue Code provisions governing dividends paid by the foreign subsidiary. See, *e.g.*, 26 U.S.C. 316(a); 26

C.F.R. 1.902-1(a)(9). The dollar-for-dollar credit provided in 26 U.S.C. 901, however, is reserved for foreign taxes that have the predominant character of a U.S. income tax. That provision is an exemption from taxation that must be narrowly construed. *Texasgulf, Inc.*, 172 F.3d at 214; *Keasbey & Mattison Co.*, 133 F.2d at 898. It should not be extended to foreign taxes, such as the U.K. windfall tax, that do not have the essential features of the U.S. income tax.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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JANUARY 2013

REPLY BRIEF

No. 12-43

In the
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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RULE 29.6 STATEMENT

PPL Corporation is a publicly traded Pennsylvania corporation. No publicly held company owns 10% or more of PPL Corporation's stock.

The following subsidiaries of PPL Corporation have an interest in this litigation: (1) PPL Energy Funding Corporation, which is wholly owned by PPL Corporation; (2) PPL Global, LLC, which is wholly owned by PPL Energy Funding Corporation; (3) PMDC International Holdings, Inc., which is wholly owned by PPL Global, LLC; and (4) PPL UK Holdings, LLC, which is wholly owned by PMDC International Holdings, Inc.

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REPLY BRIEF

As the Tax Court correctly understood, the United Kingdom's windfall tax is a tax on value in name only. In practical operation, its predominant character is a straightforward excess profits tax on 51.75% of profits above a designated floor (4/9 of flotation value). Although it was nominally structured as a tax on the difference between two "values," one of them was based entirely on actual profits over a four-year period. The tax so clearly operated as a tax on excess profits that even its sponsors referred to it as such. Unless form entirely trumps substance—contrary to long-settled case law, the regulations, and the Commissioner's own position in other cases—this tax must be treated as a creditable excess profits tax.

PPL's opening brief argued at length that form does not trump substance, and that construing the domestic tax consequences of foreign taxes is the last place in which a form-over-substance rule would make sense. The Commissioner does not directly take issue with any of that, but nonetheless insists that United States tax authorities and courts must take the base and rate of a foreign tax as a given. But there is no coherent reason to treat the base and rate of a foreign tax as sacrosanct, while looking to substance only when it comes to other aspects of the tax. Nothing in the statute or regulation supports that counterintuitive rule. To the contrary, the regulation explicitly rejects a form-over-substance approach and affirmatively authorizes looking beyond a foreign government's designation of "gross receipts" or "wages" as the tax base to determine

whether the tax reaches net income in practical operation.

Indeed, this case perfectly illustrates the logical problems with the Commissioner's insistence that form trumps substance when it comes to a foreign tax's base and rate. The windfall tax nominally imposes a 23% tax on a windfall value. But it does not measure the tax base using any ordinary metric of value. A normal value calculation avoids hindsight bias and focuses prospectively on, *inter alia*, the future income-generating potential of an asset. The base here is generated by a backward-looking calculation driven entirely by actual, realized profits over a four-year period. Moreover, a traditional value tax is imposed on the holder of the valuable asset, which here would be the companies' shareholders. But this tax is imposed on the income-generating companies themselves, which makes perfect sense if the tax is in substance an excess profits tax, but no sense at all if it is a traditional tax on value.

The Commissioner's other objections all depend on the flawed premise that form trumps substance when it comes to the base of a foreign tax. The Commissioner complains that this tax does not operate in the same manner as traditional U.S. excess profits taxes. But once the means of calculating the floor of the tax is distinguished from the tax on the profits in excess of the floor (something a substance-over-form approach surely allows), the tax operates in precisely the same manner as past U.S. excess profits taxes. The Commissioner also complains that the tax does not satisfy the

regulation's three-part test. But the Commissioner reaches that conclusion only by applying the requirements to the form of the tax, rather than to its substance, an approach the regulation itself forbids. The substance or "predominant character" of the tax clearly satisfies each requirement.

In the end, this case really does turn on the fundamental and recurring question of whether form should trump substance. Tax law generally looks beyond form to substance, and there are particularly compelling reasons to do so when determining the domestic tax consequences of foreign taxes. That is enough to decide this case. The windfall tax is in practical operation a classic excess profits tax. Accordingly, it should be creditable.

ARGUMENT

I. Whether The Windfall Tax Is Creditable Turns On Its Substance, Not Labels Or Form.

It has long been settled that form cannot trump substance when it comes to tax laws. The Commissioner ostensibly accepts that venerable principle, but nonetheless insists that it does not control with respect to "the relevant foreign law's designation of the applicable tax rate and the base on which the tax is imposed." Resp.Br.28. As the Fifth Circuit recognized, the Commissioner's plea for a limited and largely unexplained exception to the general rule is "easy to dispatch." *Entergy Corp. & Affiliated Subsidiaries v. Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012).

There is certainly no reason why foreign tax bases and rates should be the lone exceptions to the

prevailing preference for substance over form. To the contrary, determination of the domestic tax consequences of foreign taxes enacted in myriad different languages and in the context of varying tax schemes and political and economic environments is the last place where such a rule would make sense. *See* Op.Br.26–27. Moreover, the Commissioner's proposed approach produces absurd results. There is self-evidently no substantive difference between a 30% tax on income and a 15% tax on a base of two-times-income. Nonetheless, by the Commissioner's logic only the first formulation is creditable because the "base" of the tax in the second formulation (which must be "taken as given") would be "*greater* than" income. Resp.Br.38–39.

This is not the *reductio ad absurdum* of the Commissioner's position; it is his position in this very case. He is, after all, defending a Court of Appeals decision that deemed the difference between a 23% tax on 225% of profit and a 51.75% tax on 100% of profit outcome determinative despite their mathematical equivalence.[1] The Commissioner

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[1] Relatedly, the Commissioner repeatedly emphasizes that the base windfall amount to which the 23% nominal tax rate is applied is greater than the companies' reported profits. Resp.Br.13–14, 36–39. But that comparison has no substantive relevance. The U.K government could have achieved the exact same result with a smaller base and a higher rate, and then reported profits would have exceeded the base. The substantively relevant comparison is not between the base and net profits (which reveals nothing of substance) but between the revenue generated by the tax and net profit (which confirms that the tax is not on something *greater than* profits). *See infra*

recognizes that "[f]or purposes of computing a particular privatized company's windfall-tax liability," *i.e.*, as a matter of substance, a 51.75% tax on profits above a threshold and 23% tax on "windfall value," which is determined by profits, "are indeed equivalent." Resp.Br.27. But according to the Commissioner, that substantive equivalence is "just a matter of algebra." Resp.Br.27. What matters—indeed, all that matters—in his view is the foreign country's "choice between the two" mathematically equivalent formulations; that choice "determines whether the ... tax is properly viewed as a tax *on* income." Resp.Br.27.

The Commissioner does not even attempt to explain why a statute designed "to mitigate the evil of double taxation," *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932), would function in such a bizarre fashion. He instead insists that his arbitrary interpretation is compelled by the regulation because its net income requirement refers to how "the *base* of the tax is computed." Resp.Br.38. (quoting 26 C.F.R. § 1.901-2(b)(4)(i) (emphasis added)). But the regulation explicitly rejects a form-over-substance approach both generally, *see* Op.Br.32–35, and specifically when it comes to the base of a foreign tax. Indeed, the very provision on which the Commissioner relies directs an inquiry that looks beyond formalism: "A foreign tax satisfies the net income requirement if, *judged on the basis of its*

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p. 21. And the tax bill for every company that paid the windfall tax was substantially less than its actual, realized profits for the relevant period. Pet.App.79.

predominant character, the base of the tax is computed by reducing gross receipts ... to permit [r]ecovery of ... significant costs and expenses[.]" 26 C.F.R. § 1.901-2(b)(4)(i) (emphasis added). As that language makes clear, the "base" of a foreign tax, just like the rest of it, is to be "judged on the basis of its predominant character," not the labels or form the foreign country gives it.

If the base of a foreign tax were sacrosanct, then a tax nominally levied on "gross receipts" or "wages" could never be credited as a tax on income or profits. Yet the regulations expressly permit "[a] foreign tax whose base is gross receipts" to be creditable "where that tax is almost certain to reach some net gain in the normal circumstances in which it applies." *Id.* § 1.901-2(b)(4)(i). The regulation also provides a tax nominally on wages as an example of a creditable tax reaching net income. *Id.* § 1.901-2(b)(4)(iv), ex. 3.[2]

The incompatibility of the Commissioner's formalism and the regulation is reinforced by the substance-over-form case law the regulation was designed to memorialize. The Commissioner erroneously contends that those decisions do not

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[2] The Commissioner thus focuses on the wrong "Example 3." Example 3 of what constitutes "gross receipts" in the U.S. sense is, as even the Commissioner concedes (at 37), irrelevant because it deals with *imputed* gross receipts, which are not at issue here. *See* Op.Br.46–47; *Entergy*, 683 F.3d at 237–38; American Elec. Power Co. ("AEP") *Amicus* Br. 24–29. Example 3 of the regulation's explanation of "net profits," by contrast, is relevant because it makes clear that the tax base is not sacrosanct; even a tax nominally on gross wages is creditable if it reaches net gain.

allow courts to "adopt an understanding of the applicable tax base different from that specified in the relevant foreign law." Resp.Br.31–32. In fact, that is exactly what those cases did. Many involved taxes nominally levied on "gross receipts," which quite obviously are not the same thing as net profits. Yet the courts went beyond labels to examine the practical operation of the taxes.

Nowhere is that more obvious than in *Seatrain Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942). There, Cuba replaced a 6% tax on net profits (which clearly was creditable) with a 3% tax on gross income (which just as clearly would not be creditable if the nominal tax base were sacrosanct, as posited by the Commissioner). Rather than treat the tax base as a given, the court looked beyond labels and form and held the tax creditable because the combination of an expanded base and a reduced rate meant the tax would continue to reach net gain in practical operation. *Id.* at 1081; *see also Bank of Am. Nat'l Trust & Sav. Assoc. v. United States*, 459 F.2d 513, 520–21 (Ct. Cl. 1972) (citing *Seatrain* for proposition that "a gross income tax which embodies within itself (*via the rate or otherwise*) consideration of the taxpayer's relevant costs and expenses" is creditable (emphasis added)). The Commissioner's approach cannot be reconciled with *Seatrain* or the other pre-regulation cases; it would treat the 3% tax on gross income as non-creditable, just like the hypothetical 15% tax on two-times-income (or the not-so-hypothetical 23% tax on 225% profits), by looking to form, not substance, when it comes to the tax base.

To be sure, neither the regulation nor the case law it memorializes deals specifically with a tax that looks exactly like the windfall tax. But that does nothing to undermine the venerable substance-over-form principle. The Commissioner cannot point to *a single* situation in which the statute, regulation, or case law instructs courts to confine the creditability analysis to the labels and form used by a foreign country, rather than to consider the foreign tax's practical operation and predominant character. That is because it would make no sense to allow a foreign country's "choice" between different formulations of a tax with the same practical effect to be outcome determinative when it comes to the U.S. tax consequences.

II. The Predominant Character Of The Windfall Tax Is That Of A Tax On Income.

There can be no serious question that the practical operation of the windfall tax is as an excess profits tax. *See* Op.Br.37–40; Entergy Corp. *Amicus* Br. 11–14. The Commissioner concedes that the tax is the mathematical equivalent of a 51.75% tax on profits in excess of the floor (4/9 of flotation value). Resp.Br.27. He concedes that SWEB confirmed the direct correlation between its profits and the amount of the tax when it was permitted to make an after-the-fact downward adjustment to its reported profits during one of the four relevant years and reduced its windfall tax liability by 51.75% of the adjustment. Resp.Br.25 & n.2. And he concedes that the initial-period profits used to calculate the windfall tax consist of "net gain" as defined by the regulation's three-part test—*i.e.*, they were measured by

subtracting significant costs and expenses from realized gross receipts. Resp.Br.21. In other words, the Commissioner concedes every factor that proves the predominant character of the windfall tax is that of an income tax in the U.S. sense.

The Commissioner nonetheless maintains that the tax is not an excess profits tax. He argues, first, that it is in substance a tax on "value" and, second, that it does not satisfy the regulation's three-part test. Both contentions are meritless.

A. The Windfall Tax Does Not Tax Any Recognizable Concept of Value but Clearly Taxes Income.

Cobbling together different features of taxes on real property and closely held companies—*i.e.*, situations in which a measure of value is not readily available on a stock exchange—the Commissioner asserts that the U.K. statute is not creditable because its notion of "value in profit-making terms" resembles "familiar" and "well-established" methods of measuring value. Resp.Br.15, 20. Both the legal and factual premises underlying this argument are incorrect. The ultimate legal question under the foreign tax credit statute is whether a foreign tax is in practical operation an income or excess profits tax, not whether it can be characterized as a value tax. There is nothing talismanic about the label "value tax." While a true value tax clearly is not a tax on income, if a foreign nation adopts an idiosyncratic definition of "value," such that "value" is measured exclusively in terms of realized income, the tax is creditable. Moreover, as a matter of fact, there is nothing remotely "familiar" about the method by which the

windfall tax measures "undervaluation." By focusing on past profits (rather than future income-producing potential), imposing the tax on the income-generating company (rather than the asset-holding shareholders), and ignoring a readily available measure of value, the U.K. government imposed a tax that looks nothing like any "well-established" means of taxing value.

The Commissioner largely glosses over the most anomalous feature of the windfall tax, which is that the *sui generis* concept "value in profit-making terms" purports to measure a retrospective value by using profits already earned during a four-year period that *pre-dates* imposition of the tax. Valuation of an asset or a company turns on, *inter alia*, its ability to produce income in the future. A measure of value based exclusively on past profits is thus highly anomalous, if not an outright oxymoron.

As every prospective investor is warned, past performance is no guarantee of future results. For that basic reason, any traditional effort at valuing a company focuses on its future income-producing potential. John A. Bogdanski, *Federal Tax Valuation* ¶ 3.05[4][d][i] (2012) ("Income-based valuation techniques look to the future; thus, the goal is to project the future income of the asset or entity."). Past earnings and profits are relevant only to the extent they shed light on future income-producing potential. Even then, other considerations, such as the value of a company's assets, are factored into the calculation. This is well-illustrated by the familiar stock market phenomena that companies with no established earnings sometimes trade at higher prices than more established companies, and that

price-to-earnings and even price-to-predicted-earnings ratios vary among sectors and companies within sectors. In contrast, as one of its principal drafters opined, the windfall tax incorporates "an underlying concept of value (based on actual ex-post earnings) that would be alien to any valuer." JA292.

The Commissioner suggests that the atypical valuation method here reflects the unusual circumstance that the U.K. government was not trying to assess or tax current value. Instead, according to the Commissioner, the U.K. government was trying to measure the "undervaluation" of the companies' stock at a particular past moment (namely, the point of flotation), and therefore it made sense to consider actual reported profits in the years after flotation.

There are several difficulties with this argument, not the least of which is that it wholly undermines the Commissioner's argument that holding this anomalous tax creditable would "greatly expand the universe of" creditable taxes. Resp.Br.15. Precisely because a traditional value tax is assessed on the basis of a current value that at best indirectly reflects *future* income-producing potential, there is no risk that such traditional value taxes can be restated as the algebraic equivalent of taxes on *past* profits. And because the Commissioner's regulation requires a foreign tax to be imposed on *realized* income, it already excludes taxes on anticipated *future* income. 26 C.F.R. § 1.901-2(b)(1)–(2).

The windfall tax is thus critically different from any normal (and non-creditable) value tax because unlike such traditional value taxes—and unlike any

other tax the Commissioner identifies—the windfall tax uses a company's actual, realized profits to measure tax liability. *Compare id.* §§ 20.2031-2(f)(2) & 25.2512-2(f)(2) (considering "prospective earning power"), *id.* §§ 20.2031-3(b) & 25.2512-3(a)(2) (considering "demonstrated earning capacity"); Resp.Br.18 (collecting state taxes that consider "ability to generate income"); Rev. Rul. 59–60 § 4.02(d) ("[p]otential future income is a major factor in many valuations of closely-held stocks"). Therefore, recognizing that this highly unusual tax operates in substance as a tax on actual, realized profits will not affect the creditability of more traditional value taxes. There is no slippery slope.

But the problems with the Commissioner's position do not end there. Efforts to reconstruct a historical value are unusual but not unprecedented, and the cardinal rule in such valuation efforts is to avoid hindsight bias. The basic concept of fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." 26 C.F.R. § 20.2031-1(b). For the obvious reason that one cannot have reasonable knowledge of facts that do not yet exist, income earned or events occurring after the valuation date may not be considered. *See* Bogdanski ¶ 3.05[4][d][i] & n.387 (collecting cases applying "general rule against use of hindsight evidence in valuation matters"). With the benefit of 20/20 hindsight, it is obvious that companies like Apple and Google "should have been" valued more highly at their initial public offerings, but any actual effort to fairly value

those companies at the time would have to avoid such biases. Indeed, the Commissioner conspicuously fails to identify any U.S. tax or valuation method that uses hindsight evidence to assess after-the-fact value.

Relying on the four years immediately after flotation is problematic as a true measure of value for yet another reason: Those years were marked by an unusual regulatory regime with a known expiration date. Op.Br.6–7. In any traditional effort to value a company, the existence of an anomalous and soon-to-be-eliminated regulatory environment would require profits for those years to be taken with a large grain of salt, either heavily discounted or discarded entirely. In short, while unexpectedly large profits during a highly unusual and discontinued regulatory regime may be a tempting target for an excess profits tax, they are a particularly flawed measure of value.

Moreover, the windfall tax is fundamentally unlike any traditional value tax because it is not assessed on the taxpayers who own (or owned) the valuable asset. If the windfall tax were really directed at recapturing undervaluation of the companies at the time of flotation, it logically would be assessed on the individuals who paid "too little" for the floated shares, not on the companies that subsequently earned "too much."

The windfall tax is also clearly something other than a traditional value tax because it ignores a ready measure of the companies' value: the price at which they traded on the London Stock Exchange. Some assets are difficult to value precisely because of the absence of a highly liquid and efficient market in which willing buyers and sellers set prices that

reflect value. That is not a problem with publicly traded companies because their value is readily ascertainable by reference to their stock price. Indeed, because stock price typically "presents such impressive evidence of value that it is deemed to be conclusive," more speculative valuation methods are considered "inappropriate" for such companies. Bogdanski ¶ 3.05[3]; *see also* Rev. Rul. 59–60 § 3.03.

It is thus no accident that the Commissioner's collection of various tax provisions that reference using future income projections to estimate current value all involve difficult-to-value assets like real estate and closed corporations, not publicly traded companies. *See, e.g.*, Rev. Rul. 59–60 (valuation method for "stock of closely held corporations, or the stock of corporations where market quotations are not available"); 26 C.F.R. §§ 20.2031-2(f)(2) & 25.2512-2(f)(2) (valuation method for stock "[i]f ... actual sale prices and bona fide bid and asked prices are lacking"); Resp.Br.18–19 (collecting state real estate taxes). Tellingly, the sole tax the Commissioner cites that permits use of income-based valuation in lieu of more accurate indicia of value (like recent sales prices) is an estate tax designed to subsidize owners of farm land and avoid the break-up of family farms by taxing their property at below fair market value. *See* 26 U.S.C. § 2032A.

The Commissioner suggests that the windfall tax ignores stock price "because Parliament was attempting to value the companies as of the date of flotation," and stock price at any later time would be "an inadequate proxy." Resp.Br.22. But the stocks of privatized companies began trading at a premium

over their flotation value almost immediately. JA86–90, 456–57. The market thus provided a measure of undervaluation at flotation that was far more compatible with traditional valuation methods. Instead, the windfall tax uses a formula with at best only a "very weak relationship" to each company's increase in value as measured by its stock price in the months or years following flotation. JA471–76. The prerogative to choose a formula based on realized profits rather than more traditional valuation methods obviously belonged to the U.K. government. But there is no reason for U.S. tax authorities to ignore the substance of that choice and treat the windfall tax as if it were a more traditional value tax.

In any event, whether the windfall tax is properly classified as a "value tax" is ultimately not the relevant question. The tax is certainly unlike traditional value taxes, but what matters under the statute and regulation is that in practical operation it reaches net gain. If a country adopted an idiosyncratic concept of value and imposed a "value tax" on companies where the sole measure of taxable value was net income in the previous year, surely that tax would be treated as an income tax. The windfall tax differs from that hypothetical tax only in the details, and those details all stem from the reality that the windfall tax is an excess profits tax, not an ordinary income tax. The windfall tax looks back four years, rather than one, because there was a four-year period marked by an unusual regulatory regime that resulted in profits perceived to be "too high." And it employs a more complicated formula—23% of the difference between two values, one of

which is a product of profits over the four-year period—because every excess profits tax must have a threshold to determine which profits are "excessive," and the windfall tax builds the threshold into the formula. At the end of the day, both the hypothetical tax and the windfall tax impose a tax on something labeled value, but in reality calculate the tax based solely on net gain. In any system in which creditability does not turn exclusively on labels, both taxes are creditable taxes on income and excess profits.

B. The Windfall Tax Is in Substance an Excess Profits Tax.

The Commissioner's attempts to demonstrate that the windfall tax fails the regulation's realization, gross receipts, and net income requirements suffer from the same fatal flaw as his broader argument: He erroneously assumes the "base" is sacrosanct and thus applies the regulation to the form of the foreign tax. *See* Resp.Br.42 ("There are infinite ways to express the algebraic formula that is the windfall tax, but the classification of the tax should be based on the iteration selected by Parliament."). But the regulation—and the substance-over-form principles it reflects—commands the opposite approach. The Commissioner stresses that a tax is creditable "*if and only if*" it satisfies each regulatory requirement, Resp.Br.34, but he emphasizes the wrong regulatory language. The key point is not that all three requirements must be satisfied, but that each must be applied to the tax "*judged on the basis of its predominant character*." 26 C.F.R. § 1.901-2(b)(1) (emphasis added). The predominant character of the

windfall tax is a 51.75% tax on initial-period profits in excess of the floor (4/9 of flotation value). Because there is no dispute that a 51.75% tax on those profits satisfies the three-part regulatory test, this should be a straightforward case.

The Commissioner protests that the windfall tax is not a *true* tax on profits because it uses flotation value and a fixed price-to-earnings ratio to determine how much profit to tax. Resp.Br.24–25.[3] But that is just what makes it an *excess* profits tax rather than a simple income tax. Excess profits taxes routinely use something other than income to set the floor above which profits will be deemed excessive, and application of the regulation necessarily must focus on the tax above the floor, not the factors used to determine the floor. *See* AEP *Amicus* Br. at 6–9; 13–16. For example, the Commissioner identifies as paradigmatic excess profits taxes both a 1917 tax on profits in excess of the sum of $5,000 and 8% of the taxpayer's "actual capital invested," and a 1940 tax on profits in excess of either the taxpayer's average profits during the three previous years or a specified percentage of return on its capital investment. Resp.Br.25–26. The use of factors that clearly would not satisfy the three regulatory requirements (such as a percentage of invested capital) to set the floor did not make those taxes any less taxes on income.

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[3] The Commissioner understandably does not take up his *amici*'s meritless argument (at 31–32) that the windfall tax is not a tax at all; he correctly conceded in the Tax Court that the windfall tax was not a payment "in exchange for any specific economic benefit." JA31.

What matters is not whether the *floor* satisfies the net gain test, but whether the amount *in excess* of the floor—*i.e.*, the amount that is actually being taxed—consists of net gain. *See* AEP *Amicus* Br. 6–9 (collecting examples of foreign excess profits taxes treated as creditable despite non-creditable factors used to calculate floor).

The practical operation of the windfall tax is no different from those paradigmatic examples of excess profits taxes that Congress intended to make creditable. It imposes a floor (4/9 of flotation value) and then imposes a 51.75% tax on any actual, realized profits above that floor. To be sure, the windfall tax looks slightly different on its face from those other taxes because, rather than state the floor and tax base in excess of the floor separately, it essentially builds the floor into one of the "values." But once the floor is separately identified, the tax looks exactly like a traditional excess profits tax. In other words, while the formula in the windfall tax statute multiplies profits by 9/4 and subtracts flotation value (and then multiplies by 23%), all agree that is the mathematical equivalent of multiplying flotation value by 4/9 and subtracting it from profits (and then multiplying by 51.75%). Only the most extreme devotee of form-over-substance could treat those substantively identical taxes differently.

The Commissioner's emphasis on the fact that profits are not the only variable in the tax is therefore both misleading and irrelevant. The only other "variable" (flotation value, which was known) is used solely to determine the floor above which profits are excessive. And, as demonstrated, factors other than

profits are commonly used in setting floors for paradigmatic excess profits taxes. But once the floor is reached, the *only* thing that determines tax liability is how much initial-period profit a company made. That is why SWEB was able to reduce its tax liability by 51.75% of every pound by which it reduced its reported profits—once its profits exceeded the floor (4/9 of its flotation value), all that mattered (*i.e.*, the actual base of the tax) was how many pounds of profit it reported.[4]

For similar reasons, the Commissioner gets no further by pointing out that two companies could have made the same amount of initial-period profit yet paid different amounts of windfall tax if they had different flotation values. Resp.Br.24. That is true of any excess profits tax (including the Commissioner's 1917 and 1940 examples) where the floor is measured by a taxpayer-specific figure other than current-period profits, such as invested capital or past profits. What matters is that once a company is above the floor, every additional pound of profit is taxed, and nothing other than the amount of profit above the

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[4] While "flotation value" may not be a common feature of U.S. excess profits taxes, Resp.Br.25, that is largely a product of the historical reality that the United States has not had nationalized companies it then decided to privatize. In that context, flotation value is an appropriate proxy for invested capital, JA70–72; *see also Entergy*, 683 F.3d at 238, which has been used as a floor for U.S. excess profits taxes. In all events, no matter how novel the mechanism for calculating the floor, what matters is whether the taxed amount in excess of the floor is income or profits, which it clearly is here.

floor and the effective rate determines the amount of tax.[5]

The Commissioner suggests that a tax is not "necessarily" an income tax just because it "is calculated using profits as a variable" or "is not confiscatory of net gain." Resp.Br.23, 28. PPL has not suggested otherwise. Rather, it has emphasized that once a company reaches the floor (4/9 of flotation value), actual, realized profits are not just "a variable"; they are the sole variable that determines the amount of the tax. That reality, which the Commissioner does not and cannot dispute, ensures that the windfall tax is not just "likely," but certain, "to reach net gain in the normal circumstances in which it applies." 26 C.F.R. § 1.901-2(a). That distinguishes the windfall tax from every true value tax the Commissioner cites, *see supra* pp. 11–12, and ensures that it is creditable.

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[5] The Commissioner's *amici* emphasize (at 15–16) that a handful of companies had different effective tax rates due to their shorter initial periods. But the predominant character test requires courts to disregard outliers and focus on the practical operation of a tax "in the normal circumstances in which it applies." 26 C.F.R. § 1.901-2(b)(1); *see also* Op.Br.38 n.3; *Exxon Corp. v. Comm'r*, 113 T.C. 352 (1999) (disregarding circumstances of a few small oil producers in rejecting an earlier effort of the Commissioner to deny creditability to a U.K. excess profits tax). In any event, the portion of each company's initial-period profits taxed was (by design) sufficiently low that no company's tax liability exceeded its net profits. For example, while Railtrack Group's effective tax rate was about 239%, the tax was imposed on only roughly a quarter of its £253 million in initial-period profits, resulting in a windfall tax liability of approximately £156 million.

Likewise, PPL did not contend that the undisputed fact that the actual windfall tax imposed (as opposed to its base) was less than actual, realized profits for every company that paid the tax (*i.e.*, that it is not confiscatory of net gain) *sufficed* to make it creditable. Rather, PPL made that point only to demonstrate conclusively that the tax does not reach something *more* than income in the U.S. sense. While not alone determinative of creditability, the comparison between revenue collected and net profits is, unlike the Commission's repeated comparison of the tax base and net profits, at least relevant. *See supra* n.1. What is ultimately determinative of creditability is the undeniable fact that, once the floor is met, the windfall tax is a straight-line tax on actual, realized profits.

The Commissioner is equally off base in dismissing the repeated recognition of everyone involved in the creation and passage of the windfall tax that it was in substance an excess profits tax. Resp.Br.43–46. As the Tax Court explained, those constant characterizations of the tax as an excess profits tax matter not as part of some effort to use legislative history to demonstrate that Parliament really wanted to impose an "excess profits tax," and not a "value tax," or because Parliament's "political motivation for the windfall tax" is controlling. Pet.App.80. Rather, those statements matter because they demonstrate that everyone involved—from the drafters of the tax, to the Labour government members who presented it, to the Parliament members who enacted it—"understood" that the tax, "by its terms, represented one of two equivalent explanations" of the same practical effect.

Pet.App.80. In other words, everyone understood that there was no substantive difference between describing flotation value as "too low" vis-à-vis profits (and taxing the "undervaluation") and describing profits as "too high" vis-à-vis flotation value (and taxing the "excess profits").

That is why, even after the Labour government settled on the "undervaluation" framing as superior for presentational purposes, it continued to describe the windfall tax as a tax "on the excess profits" of the companies. *See* Op.Br.13–14 (collecting statements from Labor government referring to windfall tax as a tax on "excess profits"). Those repeated references are not examples of public officials being "off message"; rather they underscore that those who knew the tax best understood that it could accurately be described, consistent with its substance and practical operation, as a tax on excess profits.[6]

Even the Commissioner concedes that if these U.K. officials had chosen a different "presentational" form and expressly imposed a tax on profits in excess of a threshold measured by 4/9 of flotation value, the tax would be creditable. *See* Resp.Br.27. The Commissioner's position really is just that formalistic. But the mathematical equivalence

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[6] Whether members of Parliament believed the windfall tax would be creditable is irrelevant. It was, after all, the *opponents* of the tax who questioned its creditability, raising concerns that it might violate treaties designed to prohibit double taxation and invite retaliatory taxes. JA162, 169–70. Geoffrey Robinson took no position, responding only that the "question is one for the US authorities." JA163.

between two formulas that impose the same tax on the same companies cannot be dismissed as "just a matter of algebra." Resp.Br.27. As the Tax Court correctly recognized, allowing the U.S. tax consequences of two substantively identical taxes to turn on the labels employed by foreign sovereigns runs counter to the entire thrust of the statute, regulation, and case law. *See* Pet.App.71–85.

In short, what matters is not "foreign characterizations or classifications," but predominant character, practical operation, and whether a foreign tax is in substance the equivalent of a U.S. income or excess profits tax. *Biddle v. Comm'r*, 302 U.S. 573, 579 (1938). In substance, the windfall tax operated as a 51.75% tax on profits in excess of a floor. It is creditable.

CONCLUSION

The Court should reverse the decision below and hold the windfall tax creditable.

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February 12, 2013

AMICUS CURIAE BRIEF

Supreme Court
FILED
JAN 16 2013
OFFICE OF THE CLERK

No. 12-43

IN THE
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF OF ANNE ALSTOTT, MARVIN CHIRLESTEIN, MIHIR DESAI, MICHAEL GRAETZ, DANIEL HALPERIN, MITCHELL KANE, LAWRENCE LOKKEN, ROBERT PERONI AND ALVIN WARREN, AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF THE *AMICI CURIAE*

Amici are law professors who teach and have written books and numerous articles on taxation, including U.S. international taxation. Amici's interest is in the proper application of the U.S. tax laws.[1] Brief descriptions follow:

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[1] Pursuant to Rule 37.6, *amici* state that no counsel for a party authored this brief in whole or in part, and no person or entity, other than *amici* and their counsel, made a monetary contribution to the preparation or submission of the brief. As reflected in a letter filed with the Clerk, the Solicitor General has consented to the filing of this brief; petitioners have consented generally to the filing of amicus briefs in this case.

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SUMMARY OF ARGUMENT

In 1997 the newly elected Labour government of the United Kingdom enacted a Windfall Tax applicable to a relatively small group of privatized regulated utilities that years earlier had been sold to the public at a fixed price (£2.40 a share for the regulated electric companies). For the initial four or five years following privatization, the previous Conservative government had also fixed the prices that these monopolies could charge their customers.

The Windfall Tax was designed to redress both undervaluation at privatization (which for petitioners occurred in 1990) and subsequent lax regulation that permitted the utilities to charge unduly high prices during the initial period after privatization. The tax imposed is 23% of the difference between a recomputed share value (based on a fixed price-earnings multiple of earnings) and the lower value at which the shares were actually issued to the public at privatization (the "flotation value").

Based on a specific mathematical reformulation of the tax, which more than doubles its rate and ignores or obscures important variables, petitioner claims that the UK levy is an "income or excess profits tax" eligible for dollar-for-dollar reimbursement by U.S. taxpayers under the foreign tax credit of § 901 of the Internal Revenue Code. But since the value of an income-producing asset necessarily depends on its earnings, a tax on value can be restated mathematically as if it were an income tax. The idiosyncratic algebraic reformulation on which petitioner rests its entire case is only one of several equivalent mathematical reformulations, a number of which lead to the opposite conclusion that the UK tax at issue here is not a creditable income tax. Petitioner would, in effect, have this Court extend the foreign tax credit well beyond its statutory scope of income and excess profits taxes to a whole host of taxes on value and perhaps even to consumption taxes, none of which have ever been creditable.

Precisely because petitioner's reformulation would open the door to claims of foreign tax credits for foreign levies based on value, not income, if this Court accepts petitioner's argument, it would provide a road map to foreign governments, encouraging them to shift the costs of privatization to U.S. taxpayers by initially undervaluing public assets and companies sold to private interests and subsequently imposing a retroactive levy to compensate for the previous undervaluation.

Under petitioner's approach, U.S. taxpayers would reimburse a U.S. parent company dollar-for-dollar for such retroactive payments made by its foreign subsidiaries. The UK tax at issue here is not an income or excess profits tax, and no foreign tax credit should be allowed for it under § 901.

ARGUMENT

I. THE FOREIGN TAX CREDIT SHOULD NOT BE CONSTRUED EXPANSIVELY TO APPLY TO THIS LEVY

This Court has long and unanimously insisted that income tax deductions are a matter of "legislative grace" and are to be strictly construed. *E.g.*, *Indopco, Inc.* v. *Comm'r*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines* v. *Comm'r*, 319 U.S. 590, 593 (1943). Deductions are allowed only "as there is clear provision therefor." *Indopco Inc.*, 503 U.S. at 84 (quoting *New Colonial Ice* v. *Helvering*, 292 U.S. 435, 440 (1934) and *Deputy* v. *Dupont*, 308 U.S. 488, 493 (1940)).

This rule of strict construction applies *a fortiori* to tax credits. The tax savings from an income tax deduction depends on the taxpayer's income tax rate, so a deduction would save a corporation, such as the petitioner here, at most 35% of the amount deducted. 26 U.S.C. §11. In contrast, a tax credit, such as the foreign tax credit allowed by § 901 of the Internal Revenue Code, at issue here, is a dollar-for-dollar offset against U.S. tax. 26 U.S.C.§ 901.

When enacted in 1918, the foreign tax credit was an extraordinarily generous measure virtually unprecedented elsewhere. The economist Edwin Seligman remarked: "The United States is making a present of the revenue to other countries." Edwin R.A. Seligman, *Double Taxation and International Fiscal Cooperation* 135 (1928), quoted in Michael J. Graetz and Michael M. O'Hear, *The "Original Intent" of U.S. International Income Taxation*, 46 Duke L.J. 1021, 1045-46 (1997).

The Third Circuit below was surely right to emphasize that the foreign tax credit is a "privilege extended by legislative grace" that should be "strictly construed." Pet. App. 7.

If this Court were to extend the foreign tax credit to this unique UK levy it would shift the burden of this levy away from the UK utilities' shareholders—where it was intended and carefully calibrated by the UK government to fall—to U.S. taxpayers.

II. THIS ONE-TIME RETROACTIVE LEVY IS NOT IN SUBSTANCE AN INCOME TAX

We agree with petitioner, the Third Circuit, the Fifth Circuit, and the Government that the label of a foreign tax does not determine whether it is eligible for the foreign tax credit. Pet. Br. 4; Pet. App. 8-15; *Entergy Corp.* v. *Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012), petition for cert. pending, No. 12-272 (Filed Sept, 4, 2012); Res. Br. 15. We also agree with petitioner that ignoring the substance of a foreign tax in determining whether it is eligible for the foreign tax credit would be in sharp tension with this Court's opinion in *Biddle* v. *Commissioner*, 302 U.S. 573, 579 (1938). But petitioner's insistence that the Court should ignore the design, wording, structure, history, and purpose of the UK statute at issue here and rely instead simply on its own particular mathematical rewriting of the UK statute is wrong.

Petitioner insists that the UK's imposition of this tax on value, rather than on income or excess profits, is "presentational" or "political," wholly a matter of "form" without any substantive consequences. Pet. Br. 13, 27. But petitioner's repeated insistence that the Third Circuit was "wholly formalistic" Pet. Br. 17, 44, or "hyper-formalistic", Pet. Br. 47, misreads the opinion below. Instead, as we describe in Section III below, what is formalistic is petitioner's insistence that its particular mathematical restatement of the tax is the only way to understand its substance. The language, scope, and structure of the UK Windfall Tax at issue here reflects the UK government's specific concerns with the combination of undervaluation at privatization and overly generous regulation of prices to consumers during the "initial

period" following privatization.

The Windfall Tax at issue here is a one-time retroactive levy imposed by the UK Labour government on a small group of recently privatized regulated utilities to redress a combination of the prior Conservative government's undervaluation of these utilities at the time of their privatization ("flotation") and lax, unduly generous price regulation in the four or five years immediately following the privatization. Pet. App. 24-29; 37-38 (Budget Speech of Chancellor of the Exchequer Gordon Brown: "In determining the details of the tax, I believe I have struck a fair balance between recognizing the position of the utilities today and their undervaluation and under-regulation at the time of privatization."); 38 (Her Majesty's Treasury, Explanatory Notes: Summer Finance Bill 1997: "[T]he companies were sold too cheaply and regulation in the relevant periods was too lax."); 40 (Remarks of the Paymaster General Geoffrey Robinson in the Parliamentary Debate of UK Windfall Tax: "Those companies were sold too cheaply so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatization was too lax, so the customer got a bad deal."). Thus, this levy was limited to undervalued privatized utilities that had been subject to the lax regulation. Pet. App. 129-131.[2] The rate of tax was

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[2] The UK statute, enacted by Parliament in July 1997, just two months after the Labour Party took power, provides that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation

set at 23% of the "windfall." Pet. App. at 130 (Pt. I, para. 1(2)).

The "windfall" to be taxed is defined as the difference between two values: (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" minus (b) "the value which for privatisation purposes was put on that disposal." Pet. App. 138-139 (Sch. 1, ¶1). The profit-making value is determined by multiplying the average annual book profits for the company's initial period by the applicable price-to-earnings (P/E) ratio. Pet. App. 139 (Sch. 1, ¶2). A company's "initial period" is either the first four years after flotation or the period between flotation and the end of the regulated utility's last financial year that ended before April 1, 1997. Pet. App. 145-146 (Sch. 1, ¶6 (1) and (2)).

The applicable P/E ratio is set by statute at nine. Pet. App. 139 (Sch. 1, ¶2(3)). That figure represents the lowest average P/E ratio, during the relevant period, of the 32 companies subject to the tax. Pet. App. 4; J.A. 129, 135, 147-148, 153.

The second of the two values—the flotation value—is determined by multiplying the highest price per share at which shares in the company were offered during the flotation (at privatization) by the number of shares offered. Pet. App. 139-140 (Sch. 1, ¶3).

The statute, therefore, taxes at a 23% rate the

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shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." Pt. App. 129 (Pt. I, para. 1(1)).

difference between the value for which each company was actually sold (£2.40 per share for each of the 12 regulated privatized electric companies. J.A. 24-25, 364.) and a higher value for which it might have been sold, considering the prices its regulators allowed it to charge. The UK government, based on advice from its consultants at Arthur Andersen, rejected alternative taxes on gross receipts, profits, excess profits, assets, or excess shareholder returns. Pet. App. 32-33; J.A. 505-510.

No one doubts, and the petitioners seem to concede, that if the UK had used actual market values following privatization, that the UK Windfall Tax would be a tax on value, not eligible for the foreign tax credit. Pet. Br. 42. However, the UK government had good reasons for instead using a fixed P/E ratio (which ratios are commonly used to value stocks, J.A. 520-528). First, a statutorily fixed P/E ratio allowed Inland Revenue to avoid valuation disputes. J.A. 575. Even with publicly traded stocks, given the daily volatility in prices, market prices might well have produced controversies. In addition, the UK government estimated that using market values would produce three times the revenue it wanted (£17 billion rather than £5 billion), J.A. 180, and it was concerned that a tax of that size might adversely affect employment and share values within the privatized regulated industries, consequences that were avoided by the actual tax levied.[3] J.A. 127, ¶195 and 279. (Petitioner's expert

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[3] Given its penchant for mathematical equivalencies treating tax rates as variable without regard to the statute, petitioner could respond that a tax on market value differences might have been levied at a 7 2/3% rate rather than 23%, but such a

Chris Wales said: "[o]n the basis of its final scale, [this levy] was well within the means of all the companies affected").

The UK levy here was designed as a tax on the difference in *values*—rather than incomes or excess profits—to comply with European Community law and avoid Parliamentary delay or defeat. Had the UK enacted an actual tax on profits or used market values, this would have necessitated variable rates to replicate the incidence of the levy in its final form.[4] Such variability would have rendered the levy a "hybrid" tax bill in Parliament, with accompanying legislative roadblocks, and might also have offended nondiscrimination requirements in the European Union. By imposing a tax based upon formulaic differences in valuations and by basing the tax on a fixed "initial period," which for all affected companies ended prior to enactment (either for a four-year period, or, if less, the period between the date of privatization and the company's latest financial reporting year ending before April 1, 1997) the UK government was able to avoid the legislative difficulties of a hybrid tax bill. J.A. 172-173; 331-333. And structuring the tax in this uniform manner also

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low rate may not have been viewed as fulfilling the government's promises, and may well have had collateral consequences. Consider, for example, §199 of the Internal Revenue Code, which is a deduction for 9% of qualifying manufacturing income, rather than a three percentage point reduction in the 35% tax rate because the deduction has financial accounting advantages to the eligible companies. 26 U.S.C. §199.

[4] This is made clear in the next section, which demonstrates the variable rates of the levy when stated in terms of a profits base.

eliminated the prospect of challenges to the tax in in the European Court of Justice or the European Court of Human Rights as violating the nondiscrimination requirements of European Community Treaties. J.A. 509-510. See Ruth Mason, *Flunking the E.C.J.'s Tax Discrimination Test*, 46 Colum. J. Transnat'l. L. 72 (2007); Michael J. Graetz and Alvin C. Warren, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale L.J. 1186 (2006).

By taxing these companies based on the differences in values as prescribed in the UK statute, rather than based on market values, the UK government was able to redress the two specific problems it had identified: undervaluation at privatization and lax regulation during the initial period following privatization. Comprehending the latter problem requires a brief explanation of the absence of standard utility regulation by the UK government for the initial period following privatization.

Monopolistic utilities are typically regulated by setting prices based on a rate of return on their invested capital. In this traditional regulatory model, the allowable rate of return is set by the utility regulator.[5]

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[5] In *Bluefield Waterworks & Improvement Co.* v. *Public Service Comm'n*, 262 U.S. 679 (1923), this Court held that the Constitution requires that the rate of return established by a utility regulator must allow rates that are sufficient to yield a reasonable rate of return, which it defined as equal "to that generally being made at the same time and in the same general part of the country on investments in other business

The Tax Court, accepting petitioner's mathematical reformulation, described the tax here as, in the majority of cases, reaching book profits during the initial period that on average exceeded about 11.1% of the companies' total privatization value. Pet. App. 64-65, 83.[6] To reach this result, both excessive regulatory prices and an undervaluation at privatization are necessary. If the aggregate share price at flotations had been higher, the amount of "windfall tax" would have been lower. Likewise, if the prices allowed by the regulator had been lower, the amount of tax would have been lower. Thus, even under the Tax Court's and petitioner's view, the substantive effect of the UK statute was to rectify undervaluation and lax regulation by the prior government by retroactively imposing rate of return ratemaking on those companies, albeit allowing a very generous rate of return on its original flotation value. (We discuss the appropriate tax treatment of a retrospective price adjustment infra at Section VII.)

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undertakings which are attended by corresponding risks and uncertainties," but the company has "no constitutional right to such profits as are realized or anticipated in highly profitable enterprises or speculative ventures." 262 U.S. at 692-693. See also *Fed. Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (reaffirming that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks").

[6] Achieving such a uniform rate of return for most of the regulated utilities would have not been possible without using a statutory fixed P/E ratio.

III. MATHEMATICAL REFORMULATIONS OF THE WINDFALL TAX DO NOT RESOLVE THE ISSUE HERE

Petitioners insist that rather than reflecting a substantive purpose and effect, such as we have just described, the structure of the statute is solely a matter of "politics," "presentation," "labels," or "form." And petitioner repeatedly accuses both the Third Circuit and the Commissioner of Internal Revenue of "hyper-formalism." Pet. Br. 13, 20, 23, 27, 34, 44. Eligibility for the foreign tax credit here, petitioner repeatedly insists, should turn on its mathematical recasting of the UK statute as a 51.75% tax on "excess profits." *E.g.*, Pet. Br. 1, 9-10, 20. The Tax Court accepted this argument. Pet. App. 82-84. But petitioner's insistence on its particular idiosyncratic mathematical rewriting of the UK statute's tax base and rate, along with its complete rejection of the clear attempt of Parliament to enact a levy to reach undervaluation and unduly high regulatory prices to consumers, fails to transform this levy into a creditable tax. Any tax on value, when value depends on earnings, can be restated by algebra to look like a different rate of tax on earnings. Moreover, a variety of other mathematical reformulations, which show the UK levy is not creditable, are readily produced. Petitioner's extreme focus on its mathematical reformulation, to the exclusion of the language, scope, and structure of the UK statute obscures rather than elucidates the substance of the levy.

As petitioner's brief indicates, in order for its particular mathematical gymnastics to hold, it must treat the fraction 9/4 as fixed and unchanging.

Petitioner uses this number as an arbitrary multiplier in its mathematical reformulation. But, along with the statutory tax rate of 23%, the statute's P/E ratio of nine was consciously chosen by the UK government to accomplish its legislative purposes. Uncontradicted testimony in the Tax Court proceeding describes this P/E multiple of nine as based on the lowest P/E ratio during the relevant period by the privatized utilities, *i.e.* that for water utilities. J.A. 129 ¶4, 135 ¶11, 147, 153. Using a higher P/E multiple, say ten or eleven, would have increased the amount of tax due. (In petitioner's reformulation, this would show up as a higher tax rate.) The government's expert testified that nine was a reasonable approximation of the P/E ratio for regional electric utilities. J.A. at 523.

A. Petitioner's Reformulation is Not Mathematically Equivalent Because It Writes Crucial Variables Out of the Formula.

The Government's brief demonstrates in detail how the petitioner's mathematical reformulation ignores flotation value as a variable and shows that if that variable were taken into account, the UK levy would fail the "realization" requirement of the regulations under § 901, 26. C.F.R. §1.901-2(b)(2)(i)(A). Res. Br. 24-25, 34-36. As the Government points out, if flotation value were high enough, even if a company made substantial profits, it would owe no tax. Res. Br. 12, 24 (demonstrating that consequence for British Energy plc).

For petitioner's mathematical reformulation to

hold, one must also ignore that windfall tax liability depends upon how many days a company operated during the "initial period." As petitioner agrees, the statutory windfall tax formula is given by

$$\text{Tax}=0.23*\left[\left\{\frac{365}{D}*9*P\right\}-FV\right]$$

"P" denotes total realized profits earned after privatization in the "initial period" of unduly generous regulation, "FV" denotes the firm's flotation value, and "D" denotes the number of days the company operated as a private company during the initial tax period. Pet. Br. at 8-9.

Petitioner reaches its mathematical reformulation by replacing the "D" variable in the denominator with 1,461, the number of days in four years. That substitution produces the fixed multiple of 4/9 in petitioner's rewrite of the statute after further algebraic manipulation. While four years is the initial period for most of the regulated utilities subject to the tax, the number of days in fact varies, and, under petitioner's mathematical rewriting of the statute, this would produce variations in tax rates among the companies from 51.64% to 239.10% as shown in the following table:

Company	Initial Period (in days)	Stipulated Tax Rate Equivalent	Citation in J.A.
27 Windfall Tax Companies Including PPL	1,461 (4 years)	51.71%	J.A. at 37 ¶ 158.
Powergen plc	1,463 (4 years)	51.64%	J.A. at 38-39 ¶¶ 162-63.
National Power plc	1,456 (4 years)	51.89%	J.A. at 39-40 ¶¶ 164-65.
Northern Ireland Electricity plc	1,380 (less than 4 years)	54.75%	J.A. at 40 ¶¶ 166-67.
Railtrack Group plc	316 (less than 4 years)	239.10%	J.A. at 40-41 ¶¶ 168-69.
British Energy plc	*No windfall tax liability.*		J.A. at 33 ¶ 146.

So, petitioner's insistence that the only moving part of the tax is profits is not correct. Petitioner's reformulation should not be relied upon to determine

the predominant character of this UK levy because it ignores variations in flotation value and obscures the fact that tax liability—for all firms—depends on the number of days the firm operated during the tax period. Treasury regulations under § 901 are clear: With exceptions not relevant here, "a tax either is or is not an income tax in its entirety for *all* persons subject to the tax." 26 C.F.R. §1.901-2(a)(1) (emphasis added).[7]

Because the windfall tax was retroactive, the UK government knew when they designed this levy that 16% of the firms subject to it (5 out of 32) would have a different value for the "days in operation" variable than others. It could have chosen to tax each firm on the profits it earned during the tax period, regardless of the number of days it took for the firm to earn that profit. Instead, the government made liability depend explicitly on the number of days a firm operated during the taxable period. This choice—to scale profits by days in operation—belies the windfall tax's predominant character being that of a tax on income.

Even using the petitioner's mathematical version of the tax, a tax of 239.10%, which under its own calculations would apply to Railtrack Group plc, is not an income tax or a tax on net gain as required by 26 C.F.R. §1.901-2 (a)(3)(i). Petitioner simply treats

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[7] In holding for the petitioner, the Tax Court wrote this requirement out of the regulations on the ground that the Commissioner failed to insist upon it in a prior Tax Court proceeding involving a different tax and different taxpayers. Pet. App. 57, n15; 82, n33. (citing *Exxon Corp.* v. *Commissioner,* 113 T.C. 338 (1999).

Railtrack as some "outlier," whose tax rate is irrelevant. Pet. Br. 38, n.3.

B. Many Non-Creditable Taxes Can Be Reformulated to Depend on Income Because of the Close Relationship Between the Value of an Asset and the Income it Produces.

The foreign tax credit is available only for income taxes and excess profits taxes and does not apply to taxes on value or a retroactive adjustment in regulatory pricing. 26 U.S.C. § 901. Mathematical rejiggering, however, can virtually always be deployed to convert a tax on value or a corrective to excessive pricing into a different rate tax on profits.

Indeed, any tax on the value of an income-producing asset can typically be recast as a tax on profits since the value of income-producing assets derives from their income. The value of any income-producing asset is the present discounted value of all future income. The value of equity in a corporation is determined by future profits, the appropriate discount rate, and the growth rate of those profits. In the case of an infinitely lived company producing stable profits, today's value may be represented by this equation:

$$\text{Value} = \text{Profits} \div \text{Discount Rate}^{8}$$

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[8] For simplicity of exposition, the formula in the text ignores the growth rate of profits. Including the growth rate, one would rewrite the equation as follows: Value = Profits × (1 + Growth Rate) / (Discount Rate – Growth Rate). For example, assume that a company is expected to provide profits of $100

A shorthand way to convert profits into value is provided by the P/E ratio. For example, a P/E ratio of nine means that a company with $1 of profits is worth $9 today. So,

$$\text{Value} = \text{Profits} \times (\text{P/E Ratio})$$

Alternatively, profits may be understood as the difference between revenues and costs. Revenues are the product of prices charged and quantities sold, and in industries such as the regulated utilities at issue here, costs are mostly fixed costs. Accordingly, value may also be represented as:

$$\text{Value} = (\text{Prices Charged} \times \text{Quantities Sold} - \text{Fixed Costs}) \times (\text{P/E Ratio})$$

This simple relationship demonstrates the inevitable connections between profits, value, and prices in a high fixed-cost industry. Increases in prices to customers will result directly in more profits, and higher profits will result directly in a higher value via the P/E ratio. Accordingly, reinterpreting a tax on value mathematically as a tax on profits is not difficult, but neither is it helpful, given the universality of these relationships. Concerns about excessive prices will often become manifest as excess profits.

The more important point is, as we have seen, that this UK tax was fashioned to target the

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next year, that profits will grow at 2% forever, and that the appropriate discount rate is 10%. In this case, value would be $1,275 ($1,275=$100×(1.02)/(0.08)). In this example, 12.75 is the P/E ratio that results from the growth rate and discount rate assumed.

combination of unduly high regulatory prices and undervaluation at privatization. It is hardly surprising that British politicians often used the shorthand of excess profits to refer to the situation that developed. The legislative record demonstrates clearly that the target of the tax was unduly high prices during the initial period and undervaluation at flotation – and that excess profits were merely a consequence of these underlying mistakes.

Accepting mathematical translation of taxes on value (such as property taxes, wealth taxes, or estate taxes) into taxes on income would expand the scope of the foreign tax credit far beyond the annual income and wartime excess profits taxes which § 901 was designed to reach. Such a translation is almost always possible whenever the tax paid is highly correlated with the income from the relevant assets and is inevitable when one is imposing the tax retroactively as here. The Government's brief details the numerous ways in which values for purposes of the federal estate tax and state and local property taxes depend on a multiple of earnings. Res. Br. 16-20.

Like wealth taxes, non-creditable taxes on consumption are also closely related to taxes on income. Since consumption and income are often correlated, accepting mathematical reformulations of the sort used by petitioner here might also potentially extend the foreign tax credit to a variety of consumption taxes. This is, of course, exactly what at least some amici for petitioner intend. Brief for Amici Curiae Roseanne Altshuler, et.al. at 19-20, citing Charles E. McLure, Jr. and George R. Zodrow,

The Economic Case for Foreign Tax Credits for Cash Flow Taxes, 51 Nat. Tax J. 1 (1998). See also Alvin C. Warren, *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash-Flow Tax?* 52 Tax L. Rev. 1 (1996).

C. Equally Valid Mathematical Reformulations Show That This UK Levy is Not Creditable.

The Third Circuit was unwilling to accept petitioner's insistence that it treat the UK tax rate as a variable (rather than the 23% specified in the statute) and the court engaged in its own mathematical reformulation of the UK tax, even while tentatively accepting petitioner's use of 9/4 as a multiplier. Pet. App. 11. The Third Circuit uses the following equation to describe the tax:

$$Tax=23\%x[2.25xP]$$

Ibid. Based on this formulation, which surely is just as reasonable as petitioner's preferred equation, the Third Circuit held that the UK tax violates the gross receipts requirement of 26 C.F.R. §1.901-2(b)(3)(B). Pet. App. 12-13. Respondent's brief elaborates on this point and also explains other reasons why the UK tax fails to meet the specific requirements of Treasury's regulations. Res. Br. 33-42. We do not repeat those arguments here, but instead explain why such mathematical gyrations are inapt to resolve the applicability of the foreign tax credit and why petitioner's claim that the UK tax should be viewed as an "excess profits tax" under 26 U.S.C. § 901 is error.

A third mathematical equivalence, as apt as any other—given that the tax is a one-time retroactive tax—would be to restate the tax as a tax of 207% of average annual excess profits earned during the initial period. To reach this equivalence, start from the statutory windfall tax formula and accept (for the sake of argument) petitioner's assumption that the "D" variable equals four. One then obtains:

$$\text{Tax}=0.23*\left[\left\{\frac{P}{4}*9\right\}-FV\right]$$

Pet. Br. 9. Algebra then allows one to rewrite this as:

$$\text{Tax}=2.07*\left[\frac{P}{4}-\frac{FV}{9}\right]$$

This reformulation suggests that the UK government imposed a windfall levy on the excess of average annual profits (during a four-year initial period) over "normal" annual profits (calculated using the statutory P/E ratio of nine).

Such a tax, even though it reaches the same result as petitioner's algebra, is not creditable under § 901. Like the Third Circuit's formulation, this formulation clearly runs afoul of the net gain requirement of the regulations. 26 C.F.R. 1.901-2. A tax that reaches more than 100% of a profits base does not reach net gain. Such a tax is not an income or excess profits tax in the U.S. sense. The Third Circuit recognized precisely this point when it observed that a tax cannot reach net gain if it taxes more than 100% of profits. Pet. App. 8-13. Despite petitioner's insistence on its algebraic recharacterization, no one idiosyncratic

mathematical rendition of this unique tax can claim to reveal its true substance.

Petitioner repeatedly insists that its mathematical reformulation makes this an "easy" or "straightforward" case. Pet. Br. 12, 20, 21, 37. But, in fact, the inevitable relationships between value and income, prices and profits, along with the many equally relative alternative mathematical formulations of the British levy at issue here, are confounded by petitioner's insistence on its particular algebraic reformulation.

IV. THE PREDOMINANT CHARACTER OF THE UK WINDFALL TAX IS NOT AN INCOME OR EXCESS PROFITS TAX AS REQUIRED BY 26 U.S.C. 901

To be creditable under § 901, a tax must have the "predominant character" of "an income tax" in the U.S. sense. 26 C.F.R. §1.901-2(a)(1)(ii). As this Court has clearly stated: "The phrase 'income taxes paid,' as used in our own revenue laws, has...a well-understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning, which must be attributed to it as used in section 131 [the unchanged statutory predecessor to §901]." *Biddle,* 302 U.S. at 579. The Government details why the UK levy fails to meet the specific requirements of the regulations under §901. Res. Br. 33-42. Here, we show the UK Windfall Tax to be a unique levy without any precedent in U.S. income or

excess profits tax law, instead departing from that meaning in several crucial respects.

A. The UK Windfall Tax is a One-time Retroactive Levy; Income and Excess Profits Taxes are Imposed Annually and Are Prospective.

The U.S. corporate income tax has been imposed based on annual income each year since 1909; the individual income tax annually since 1913. Wartime excess profits taxes were also always levied annually during the period when they were in force. To the contrary, the UK Windfall Tax is a one-time retroactive levy based on differences in values designed to remedy the combination of undervaluation at privatization and steep prices during the period immediately following privatization.

The UK levy was imposed to remedy undervaluation and regulatory pricing shortcomings by a government that was no longer in office when the tax was enacted. It is totally retroactive in effect. U.S. income taxes are imposed prospectively and changes are generally made effective only for the period subsequent to the announcement of a prospective change in law or following enactment.[9]

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[9] It is rather common for U.S. income tax amendments to take effect on the date of announcement of congressional consideration or beginning with the year of enactment. Claims that such effective dates—a far cry from this UK statute, which reaches back many years—violate the Due Process Clause of

U.S. excess profits taxes, which petitioner urges are comparable to this UK levy have all been prospective. The Excess Profits Tax of 1917, enacted on March 3, 1917, made clear that "the first taxable year shall be the year ending December thirty-first, nineteen hundred and seventeen." Excess Profits Tax of 1917, ch. 159 §200, 39 Stat. 1000, 1000 (repealed 1921). Subsequent amendments later in 1917 and 1918 significantly changed how "normal" levels of return were calculated, but did not impose the excess profits tax retroactively. See Roy G. Blakey and Gladys C. Blakey, *The Revenue Act of 1918*, 9 Am. Econ. Rev. 213, 226-31 (1919); Roy G. Blakey, *The War Revenue Act of 1917*, 7 Am. Econ. Rev. 791, 795-97 (1917). The Excess Profit Tax in the National Industrial Recovery Act of 1933 did not operate retroactively. The statute makes clear that the excess profit tax should be imposed only in the year following the first year in which a simultaneously enacted corporate excise tax was also imposed. Ch. 90, §216, 48 Stat. 195, 208 (repealed 1945). The Excess Profit Tax of the Second Revenue Act of 1940 did not operate retroactively. Enacted in October of 1940, the excess profits tax was imposed on excess income determined with respect to "each tax year beginning after December 31, 1939." Ch. 757, §710, 54 Stat. 974, 975 (repealed 1945). Nor did the Excess Profits Tax of 1950 operate retroactively. It was enacted in January 1951 and imposed on excess profits earned in taxable years "ending after June 30, 1950...and beginning before July 1, 1953." Ch. 1119, §430, 64 Stat. 1137. In sharp contrast, the

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the Fifth Amendment have been rejected. See *U.S.* v. *Darusmont*, 449 U.S. 292 (1981).

UK tax as issue here is a one-time purely retroactive levy. (Petitioner's expert testified that the UK government rejected an excess profits tax that would operate on a prospective basis, even though, excess profits taxes "generally are prospective" and that "a typical excess profits tax is forward looking." J.A. 561, 564.)

B. The UK Tax is Based on Average Book Profits Over an "Initial Period," Not Annual Income.

This court long ago recognized that an income tax in the U.S. sense is, and always has been, imposed based on an annual accounting period. *Burnet* v. *Sandford & Brooks Co.*, 282 U.S. 359, 364 (1931) ("All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year or, at the option of the taxpayer the particular fiscal year which he may adopt.") Surely the requirement of "net gain" in the "normal circumstances of its operations in which it applies" under 26 C.F.R. §1.901-2(a)(3)(i) of the regulations implies the crucial income tax role of an annual accounting period; otherwise, it would not be describing a tax "with the predominant character of an income tax." This point is so clear that it was not essential for Treasury to restate it explicitly in the regulations. In contrast, the UK windfall tax was imposed one-time only on the shortfall in flotation values.

Even petitioner's mathematical restatement of the tax treats the base of the tax as a levy applicable to profits over a four-year period. The UK levy, however, applies only where a company (or a demerged successor) was in existence on 2nd July 1997. Pet. App. 130. For most of the UK companies (including Petitioner), the "initial period" ended long before 2nd July 1997. Pet. App. 141-43. (Schedule 1 (5&6)). Thus, if a company were to have been liquidated, say in 1995, the UK levy would have no effect at all on the profits of that historic entity. And, for companies that have demerged, the Windfall Tax liability is allocated based on the "respective market capitalisations of the companies at the time of the demerger." J.A. 130 ¶8. That treatment cannot be squared with the way an income tax actually applying over the initial period would operate. Likewise, for companies that were only partially privatized, only a proportion of the company's privatization price and subsequent value as normally calculated are taken into account. J.A. 129-130 ¶7.

As we described in Section III, petitioner's mathematical expression can be rewritten in the mathematically equivalent form: Tax = 2.07×(P/4 – FV/9); under this formulation, the levy is a one-period 207% profits tax on the excess of average annual profits (during a four year testing window) over "normal" annual profits (calculated with the statutory P/E ratio of nine). Like the Third Circuit's alternative formulation, this formulation clearly violates the net gain requirement, because it reaches more than 100% of a profits base. Pet. App. 13.

The role of average profits in the UK statute creates an additional conflict with the net gain requirement of the regulation. Profits taxes that truly reach net gain always increase as the amount of gain increases. This fundamental principle applies to any income or profits tax: for any range of net gain that incurs positive tax liability, more gain means more tax.

But this will not always happen under the UK levy. Consider a hypothetical firm ("A") with an initial period of 1,000 days that earns profits of $100 million during that time. Suppose further that A's flotation value was $300 million. It is straightforward to calculate A's windfall tax liability (under the statutory formulation), as $6,555,000. *See* Jacob Goldin, *Reconsidering Substance Over Form in PPL*, Tax Notes at 1229, 1231 (Dec. 2012). Now consider a second hypothetical firm ("B") that is identical to A in all but the following respect: B begins operating as a private company one day earlier than A, so that its initial period consists of 1,001 days. Suppose B earns total profits of $100,100,000 during that time (that is, at the same rate as A, but for one day longer). Under the UK levy, B's tax liability is $6,555,000 – exactly the same as A's liability, notwithstanding B's greater amount of profit. *Ibid.* To see an even more striking conflict with the essential principles of income taxation, consider a third hypothetical firm ("C") that operates for 1,001 days in its initial period and earns total profits of $100,005,000 during that time. C's liability would be $6,483,294. The liability would be less than A's, notwithstanding the fact that C has more profit. *Ibid.*

These examples depend on the fact that average profits rather than actual profits determine liability under the UK levy. A firm that operates for half of a year must pay the levy as if it had continued to earn profit at the same rate during a full four-year initial period. An equally profitable firm that operates for the full four-year period owes the same amount of tax as the firm that operated for six months, despite having earned eight times as much total profit. A firm that earns $50,000,000 per year owes the exact same amount whether it operates for one, two, three, or four years, even though it earns radically different amounts of profit in each of these cases. A levy that operates this way cannot meet the requirement that its predominant character be that of an income tax or satisfy regulatory net gain requirements.

And yet, this is the way the UK levy operates. Two of the firms subject to the BWT were privatized for less than one of the four years covered by the tax. In particular, Railtrack Group plc and British Energy plc operated as private companies for 316 and 260 days respectively. Despite having initial periods of less than one year, both companies were taxed according to their average profits. Consequently they paid the same amount of tax as if they had continued to earn profits at the same rate for the entire four-year period.

Moreover, the taxpayer's mathematical reformulation of the UK levy implies that Railtrack Group and British Energy were singled out for staggeringly high tax rates of 239% and 291% respectively. Petitioner offers no reason for the UK government to single out firms with later

privatization dates for such harsh "income tax" treatment. However, as the Third Circuit points out, viewing the levy as a tax on value rather than income, each firm (including Railtrack Group and British Energy) is taxed at the same rate: 23%. Pet. App. 8-14.

C. The UK Government Did Not Regard the Windfall Levy as an Income Tax.

Until it was abolished in 1999, the UK system of corporate-shareholder taxation provided shareholders with income tax credits for corporate taxes paid with respect to amounts of profits distributed by the corporation to its shareholders as dividends. Under the UK system, in order that credits be similar for all shareholders, a minimum "advance corporate tax" ("ACT") was required to be paid when dividends were distributed. This ACT was allowed to reduce or offset regular corporate income taxes imposed on the corporation. See American Law Institute, *Integration of the Individual and Corporate Income Taxes* 661-662 (1993). The UK windfall tax was explicitly prohibited from qualifying as ACT. J.A. 130 ¶9. This makes clear that the UK government did not regard this tax as having the "predominant character of an income tax," even for purposes of its own corporate income tax.

Indeed, the Parliamentary debates over the UK levy reveal that the UK Parliament did not expect the Windfall Tax to be eligible for the foreign tax credit under U.S. law. J.A. 162 (Statement of Nick

Gibb, member of Parliament from Bogor Regis and Littlehampton: "[T]he Windfall Tax is unlikely to be a creditable tax for U.S. double tax relief purposes because it is a tax on capital rather than income...") J.A. 170 ("The Paymaster General may dismiss that issue as a matter for foreign Governments, but it's a direct consequence of the ill-thought out nature of levying this tax..." *Ibid.* Mr. Gibb also pointed out that the UK Chartered Institute of Taxation had suggested that the tax could be made creditable by restructuring the tax. J.A. 170, 176; Res. Br. 46 n4.)

V. THE UK LEVY MAY NOT EVEN QUALIFY AS A TAX UNDER TREAS. REG. §1.901-2(a)(2)(i).

The Treasury regulations draw a sharp distinction between a creditable compulsory payment which is in the nature of a tax and a non-creditable compulsory payment in exchange for a specific economic benefit. 26 C.F.R. §1.901-2(a)(2)(i). The UK levy in substance is a compulsory payment in exchange for a specific economic benefit, as that term is used in the regulations. Consider a simple numerical example which models the crucial features of the UK levy. Assume a flotation of shares at a total value of £900x, premised on predicted income of £100x per year and a nine to one P/E ratio. Further, assume actual realized income of £110x per year, which would generate a valuation of £990x based on a nine to one P/E ratio. Recall that the entire scheme of the UK levy is to recapture some of the benefit realized by privatized monopolies that benefitted from unduly high prices set by the previous government during the initial period.

Mapping this characteristic onto the simple example we present here, the £10x per year "excess profit" has its genesis in the £10x per year excessive prices the government set for the regulated utility. Over a four-year initial period, the taxpayer in this example realizes £40x of excess profit from the ability to charge those excessive premiums, and the UK government would collect £20.70x.[10]

In substance, then, this arrangement reflects a £20.70x payment to the government for the specific economic benefit of charging a £40x premium over market prices. Although the regulations contain no explicit reference to a government-granted right to charge excessive prices as a "specific economic benefit," such a right is within the ambit of the general definition of that term in the regulations: "an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country." 26 C.F.R. §1.901-2(a)(2)(ii)(B). Further, the regulations list as examples certain analogous items such as "fee[s] or other payment[s]" and monopoly rights such as patents. 26 C.F.R. §1.901-2(a)(2)(ii)(B). Based on this authority alone, the UK levy may be understood as a payment for a specific economic benefit and should thus be non-creditable.[11]

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[10] The £20.70 is computed, as under the UK statute, based on the difference in values: 23% × (£990-900) = £20.70.

[11] The fact that the payment obligation arose after the granting of the economic benefit should not be dispositive. If the levy would be non-creditable if assessed during the initial period we do not see how that defect could be cured simply by delaying

VI. ALLOWING A FOREIGN TAX CREDIT FOR THE UK LEVY AT ISSUE HERE WOULD CREATE PERVERSE INCENTIVES FOR FOREIGN GOVERNMENTS AND UNDULY BURDEN U.S. TAXPAYERS

The opinion of the Tax Court makes clear that the court regards any distinction between taxes on income and taxes "imposed on the difference between two values" as unimportant. Pet. App. 81. Putting aside amounts that are spent for consumption (which would apply only to individuals and are irrelevant for corporations), the Tax Court quotes with approval economic definitions of income that equate income to the change in the market value of assets between two points in time. The Tax Court suggests that a tax based on such differences in value would qualify for the foreign tax credit under its reading of the Treasury regulations. Pet. App. 81 n.31. This is an unprecedented reading of the scope of income taxes eligible for the foreign tax credit under § 901, violates the regulatory realization requirement, and, as we have discussed, creates the potential for an unwarranted extension of the foreign tax credit to a number of taxes based on value, such as property taxes or estate taxes.

In addition to its unprecedented expansion of the foreign tax credit beyond the statutory language of §901 and beyond what that provision's history, case law, or its policy imply, treating a one-time

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the timing of the imposition of the levy, given that it applies only to those parties who received the specific economic benefit.

retroactive tax on differences in value, such as the Windfall Tax at issue here, as eligible for the foreign tax credit would provide a roadmap for foreign governments to shift the costs of acquiring privatized assets away from the owners of these assets to the U.S. fisc and American taxpayers.

In a privatization, the foreign government receives both an upfront payment from a buyer and ongoing payments of corporate tax. These are fundamentally equivalent to the foreign government, with the exception that ongoing income taxes could be creditable to a buyer resident in a foreign tax credit country. Consider a foreign government that low-balls its privatization price, with the shortfall offset by subsequent special taxes. If those taxes are creditable in the U.S., some of the privatization price would be paid by U.S. taxpayers.

This highlights how important it is to understand (a) the unique privatization setting, (b) the relationship between regulatory prices and proceeds at privatization, and (c) the potentially dangerous precedent here. Finding for the petitioner would permit foreign governments to privatize assets with low initial prices and then retroactively adjust those prices through windfall taxes in order to shift the costs to the U.S. treasury. There is no reason to extend 26 U.S.C. §901 to give foreign governments such perverse incentives to levy ex post taxes. Nor is there any reason to give foreign governments an incentive to set regulatory prices to consumers that are excessive in one period and then retrospectively tax the excess value that such prices produce, as a means of shifting the costs of the price premium to

the citizens of our nation simply because it provides a credit for foreign income taxes.

VII. THE PROPER TREATMENT OF THE UK WINDFALL TAX IS EITHER CAPITALIZATION OR A DEDUCTION TO THE EXTENT THAT EXCESS PRICES DURING THE INITIAL PERIOD INCREASED U.S. TAXABLE INCOME

As we have described—and as the record in this case makes clear—the UK Windfall Tax was enacted to address the *combination* of undervaluation when these regulated utilities were originally privatized and excessive prices due to the prior government's lax regulation during the initial period and its eschewing normal rate of return regulation.

Despite the deduction for taxes allowable under 26 U.S.C. §164(a), treating this tax as the equivalent of retroactively increasing the original privatization price could require that the tax be capitalized as an additional cost of acquisition of shares in the UK regulated companies. See, *e.g.*, *Woodward* v. *Comm'r*, 397 U.S. 572, 577-578 (1970) (confirming that all costs of acquisition of shares in a company must be capitalized); *Comm'r* v. *Idaho Power Co.*, 418 U.S. 1, 17-19 (1974) (requiring capitalization of otherwise deductible costs).

In addition to undervaluation when privatized, the UK Windfall Tax also addressed the excessive prices that the prior government allowed the privatized regulated utilities to charge their customers during the "initial period." The U.S.

income tax law addresses situations like this by allowing a deduction whenever a utility collects revenue during an initial period and subsequently is required by the government to disgorge a portion of the revenues from the earlier years. 26 U.S.C. 1341. The taxpayer is permitted to deduct the subsequent payments, but only to the extent that the original revenues served to increase the taxpayers' taxable income in the earlier years (which we cannot assume here because of the UK statute's use of book rather than taxable profits). See *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969). Had the UK government turned the revenues from its windfall levy over to the utilities' customers, this would unambiguously be the appropriate treatment of the windfall tax payment here. The fact that the UK government used the proceeds instead to fund a welfare-to-work program J.A. 26 ¶99 should not change this income tax treatment. At most, the payments required under the UK Windfall Tax should be allowed a deduction, not a foreign tax credit under § 901.

CONCLUSION

For the foregoing reasons, the opinion of the Third Circuit below should be affirmed.

Respectfully Submitted.

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AMICUS CURIAE BRIEF

No. 12-43

IN THE

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF OF AMERICAN ELECTRIC POWER COMPANY, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICUS CURIAE*[1]

American Electric Power Company, Inc. (AEP) is a public utility holding company. Through its affiliates, AEP ranks among the nation's largest generators of electricity, and it owns the nation's largest electricity transmission system. It services approximately 5.3 million U.S. customers in eleven states.

During 1997, AEP owned, indirectly through its subsidiaries, a 50% interest in Yorkshire Electricity Group, PLC, one of the twelve privatized British regional electricity companies that were liable for the U.K. Windfall Tax. AEP has claimed foreign tax credits for its share of that liability in computing its consolidated U.S. corporate income tax liability. In 2000, AEP completed its merger with Central and South West Corporation (CSW), another public utility holding company. During 1997, CSW owned SEEBOARD Group PLC, another British regional electricity company that was liable for the U.K. Windfall Tax. In computing its U.S. corporation income tax liability, CSW claimed foreign tax credits for the Windfall Tax paid by SEEBOARD. The IRS disallowed the credits by AEP and CSW on the ground that the U.K. Windfall Tax is not a creditable tax under Internal Revenue Code (26 U.S.C.) § 901. AEP is currently disputing that disallowance in administrative proceedings before the IRS.

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[1] Pursuant to Rule 37.6, *amicus* states that no counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus* and its counsel, made a monetary contribution to the preparation or submission of the brief. As reflected in letters filed with the Clerk, all parties have consented to the filing of this brief.

The issue presented in this case concerning the creditability of the U.K. Windfall Tax under section 901 is the same issue that AEP is contesting with the IRS in its dispute. AEP therefore has a strong interest in the outcome of this case, and it filed a brief as *amicus curiae* in the court of appeals.

SUMMARY OF ARGUMENT

A. When Congress enacted the foreign tax credit in 1918, it had recently enacted excess profits taxes designed to help fund the First World War. In making "excess-profits taxes" creditable in section 901, Congress thus surely contemplated that foreign taxes whose operation and effect is like those U.S. excess profits taxes would be entitled to the foreign tax credit. For the last century, section 901 has been consistently understood in that way. In particular, the IRS has ruled eligible for the credit taxes imposed on a portion of profits that exceed a specified return on capital. The 1983 regulations did not change that approach. They describe a three-part test for identifying taxes on net income that, in the context of an excess profits tax, should be applied to the portion of net income that is taxed. When making this determination, a court looks to the operation and effect of the tax, not to the labels attached by the foreign statute.

B. The Tax Court's analysis correctly showed that the operation and effect of the U.K. Windfall Tax is akin to that of a U.S. excess profits tax. Flotation value operated as a baseline below which "normal" profits were insulated from the tax, and above which "excess" profits were taxed. There was a direct correlation between a change in the taxpayer's profits and its tax liability, and companies paid no tax if they had no income.

Despite the label attached by the U.K. statute, the tax lacks the characteristics of a genuine tax on value.

C. The court of appeals erred in holding that the U.K. Windfall Tax is not creditable because of the way the statute describes the tax base. First, there is no basis for contending that the three-part test is not satisfied because of the role of flotation value in the calculation. A percentage of flotation value simply serves as the proxy for "normal" profits that are not subjected to the tax and thus is not part of the tax base to which the three-part test ought to apply. Indeed, because the quantity that defines the baseline for normal profits is typically a specified return on capital, rather than a net income figure, bringing that quantity into the net gain test would threaten the creditability of all excess profits taxes – contrary to long established administrative practice and the statutory text.

Second, there is no basis for the court of appeals' holding that the tax cannot be creditable because, under the calculation set forth in the statute, the 23% tax rate is applied to the taxpayers' excess profits only after those profits have been multiplied by two constants – a "price-to-earnings ratio" of nine and a fraction representing the length of the initial period. This argument leads to an absurd result because, as the Tax Court explained, this calculation is mathematically equivalent to a 51.7% tax on the excess profits. There is no rational reason why the two equivalent calculations should lead to a different result with respect to creditability. In either case, the tax reaches net gain, and the quantity being taxed is determined in compliance with the three-part test

of the regulations. Once the baseline for determining untaxed "normal" profits has been established, the only variable in the tax calculation is net profits.

The court of appeals misunderstood the example in the regulations that is the only authority cited for its decision. The example addresses a tax that uses "deemed" gross receipts and has no relevance to a tax like this one that is based on actual gross receipts. And the example does not address tax rates or calculation mechanics, but rather is concerned with the use of a fictitious proxy for gross receipts that would inevitably inflate net income, resulting in a tax that does not reach net gain. The U.K. Windfall Tax, by contrast, does reach net gain and does not involve a proxy for gross receipts.

ARGUMENT

The court of appeals' decision in this case turns established law governing the foreign tax credit upside down. For almost a century, it has been settled that a U.S. taxpayer is entitled to a credit for foreign tax payments if the operation and effect of the foreign tax was akin to that of a U.S. excess profits tax or income tax. In particular, if the predominant character of the foreign levy is to tax all or some of a taxpayer's realized net income, it is creditable. That rule flows from the statutory text and is consistently reflected in the case law and the regulations. The court of appeals, however, lost its way by focusing myopically on irrelevant nuances in the regulations and misinterpreting them in a way that contradicts the basic thrust of the statute. As the Fifth Circuit correctly concluded in *Entergy Corp. v. Commissioner*, 683 F.3d 233 (5th Cir.

2012), *pet. for cert. filed*, No. 12-277 (Sept. 4, 2012), there is no sound basis for not finding the U.K. Windfall Tax to be a creditable tax.

A. Section 901 Affords a Credit for a Foreign Tax Whose Operation and Effect Is Like That of a U.S. Excess Profits Tax

Section 901 of the Internal Revenue Code (26 U.S.C.) permits a foreign tax credit for "income, war profits, and excess-profits taxes" imposed by a foreign country. The predecessor to this provision was enacted in substantially the same form in 1918. Revenue Act of 1918, Pub. L. No. 65-254, § 238(a), 40 Stat. 1057, 1080 (1919). The purpose of the credit is to mitigate double taxation of earnings from foreign sources. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932) ("primary design of the provision was to mitigate the evil of double taxation"); H.R. Rep. No. 65-767, at 11 (1918) (credit designed to alleviate "severe burden" on U.S. citizens subject to "income and war or excess profits taxes in a foreign country").

Over the century that this statute has been in effect, two principles germane to the issue in this case have been consistently applied: (1) foreign taxes that operate like traditional U.S. excess profits are creditable; and (2) creditability is determined based on the operation and effect of the foreign tax.

1. Section 901 Has Been Consistently Understood to Afford a Credit for Foreign Taxes That Are Akin to a Traditional U.S. Excess Profits Tax

a. Consistent With the Statutory Text, Section 901 Has Been Administered to Afford a Credit for Traditional Excess Profits Taxes

The foreign taxes singled out for the credit in 1918 were types of income taxes that Congress itself had recently enacted during the First World War. Typically, excess profits taxes are imposed on profits that exceed some threshold amount of "normal" profits, which is often determined by reference to a company's return on capital. *See* Statement of Treasury Secretary W.G. McAdoo, *Income, Excess Profits and Estate Taxes: Hearings Before the House Comm. on Ways and Means*, 65th Cong., Part I, 15 (1918) ("By an excess-profits tax we mean a tax upon profits in excess of a given return on capital."). For example, the Revenue Act of March 3, 1917, imposed a tax on net income exceeding the sum of: (a) $5,000; and (b) eight percent of actual capital invested and employed in the business. Pub. L. No. 64-377, § 201, 39 Stat. 1000, 1000. The Revenue Act of 1918, the same legislation that enacted the foreign tax credit, imposed taxes on income in excess of a specified return on invested capital and on income exceeding a specified pre-war base. Pub. L. No. 65-254, Title III ("War-Profits and Excess-Profits Tax").[2] Thus,

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[2] Although they may employ different mechanisms to isolate profits deemed to be excessive, "war profits" taxes imposed on

in granting credits for "income, war profits, and excess-profits taxes," Congress clearly contemplated that taxes imposed on a measure of excess profits would be creditable.

Over the last century, there has been little controversy over affording the credit to taxes that operate like a traditional excess profits tax, such as the one contained in the Revenue Act of March 3, 1917. In particular, the IRS has consistently agreed that such a tax is creditable when it is imposed on a portion of a company's net profits, even if the determination of what portion of those profits are "excess" looks to quantities other than net income. If a tax on all of a taxpayer's realized net profits in a given period is creditable as an income tax, it logically follows that a tax on a portion of those net profits is creditable as an excess profits tax.

For example, in the 1950s Cuba levied a 0.4% tax on a company's real worth of capital and a 15% tax on any profits in excess of 10% of that capital. The IRS ruled that these were two distinct taxes for foreign tax credit purposes. Rev. Rul. 56-51, 1956-1 C.B. 320. The former was not creditable because it "is levied against capital valuation and is due whether or not the taxpayer has net income for the period." *Id.* The latter tax, however, was creditable as a "tax on excess profits" because it "is imposed as an additional tax on the profits subject to taxation and is due only if there is income in the

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income realized in excess of a prior base period have long been recognized simply to be a different form of excess profits taxation. *See* Robert Murray Haig, *The Taxation of Excess Profits in Great Britain*, 10 The Am. Econ. Rev. 1, 11 (Supp. 1920) ("Both standards result in excess profits taxes").

form of profits." *Id.* at 321, 320. The ruling specifically observed that it was affording the credit even though "reference must be made to the valuation of capital declared under article 14, as a basis for computing the excess profits subject to taxation under article 15." *Id.* at 320. *See also* Rev. Rul. 68-318, 1968-1 C.B. 342, 343 (Italian tax on "portion of aggregate income exceeding six percent of taxable capital"); I.T. 3381, 1940-1 C.B. 57 (Mexican tax on profits exceeding 15% of company's net worth). Thus, the IRS consistently took the position that an excess profits tax is creditable even where an integral part of the tax calculation is a valuation that determines which profits are excess.

Although not dealing specifically with excess profits taxes, the leading early precedents construing the foreign tax credit understood the reach of the credit in the same way, expounding the basic principle that "the term 'income tax' in §901(b)(1) covers all foreign income taxes designed to fall on *some net gain* or profit." *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 523 (Ct. Cl. 1972) (emphasis added). *See also Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) ("To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach *some net gain* in the normal circumstances in which the tax applies.") (emphasis added). In repeatedly referring to "some" net gain, these formulations recognized that traditional excess profits taxes imposed on a portion of a taxpayer's profits would be creditable.

As Professor Owens observed in her seminal treatise, "the issues as to the character of the tax base . . . which are inherent in identifying an excess

profits tax are the same as those involved in identifying an income tax." Elisabeth A. Owens, *The Foreign Tax Credit* 69 (1961). Focusing on the portion of the taxpayer's income that is taxed as excess profits, the IRS approach has been that "exactly the same basic doctrine and tests will be applicable in identifying an excess profits tax as are applicable in identifying an income tax." *Id.* at 69-70; *see also* 3 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 72.4.1, at 72-11 (3d ed. 2011) (the three taxes listed in the statute "can be reduced to 'income taxes' because excess profits taxes are a type of tax on income").

b. The 1983 Regulations Did Not Alter the Treatment of Excess Profits Taxes

Nothing about this approach changed when Treasury issued the current regulations in the early 1980s. Those regulations were designed to provide additional guidance on how to classify certain kinds of foreign taxes that bore some resemblance to U.S. income taxes but also had differences. In particular, they sought to deal with issues that were arising in the context of companies extracting minerals owned by foreign states, with respect to distinguishing among subsidies, royalties, and foreign income tax payments. *See, e.g.*, 2 Joseph Isenbergh, *U.S. Taxation of Foreign Persons and Foreign Income* ¶ 55.4 (4th ed. 2012) ("Isenbergh"). The regulations did not separately address any special issues surrounding excess profits taxes. *See, e.g.*, Am. Law Inst., *Federal Income Tax Project*, Tentative Draft No. 15, at 5 (Mar. 31, 1986) ("The regulations do not purport to

define 'war profits' or 'excess profits' taxes."). Rather, the regulations simply use the term "income tax" throughout, after stating that "income, war profits, or excess profits tax" will all be "referred to as 'income tax' for purposes of this section." Treas. Reg. § 1.901-2(a)(1). The regulations thus embody the teaching of prior IRS rulings as summarized by Professor Owens – whether a foreign tax is creditable as an excess profits tax will be measured by applying to the portion of the profits taxed the same tests used when an income tax is imposed on all of a taxpayer's income.

The regulatory test applicable to all taxes creditable under section 901 asks whether the "predominant character of [the foreign] tax is that of an income tax in the U.S. sense," meaning whether it "is likely to reach net gain in the normal circumstances in which it applies." Treas. Reg. § 1.901-2(a)(1)(ii), (3)(i). The regulation then fleshes out this net gain inquiry by requiring that the foreign tax, "judged on the basis of its predominant character," satisfy all three hallmarks of a U.S. income tax: (1) imposed subsequent to "realization events"; (2) imposed on the basis of gross receipts; and (3) allows recovery of significant costs and expenses such that the tax is imposed on "net income," not gross income. *Id.* § 1.901-2(b).

The new regulations plainly were not designed to radically transform settled administrative and case law that had developed over the previous 65 years under section 901. Rather, the primary focus of the regulations was to provide clarification through more detailed rules in order to "dispel the confusion" that had developed in analyzing certain kinds of tax regimes. *Texasgulf, Inc. v. Commis-*

sioner, 172 F.3d 209, 214 (2d Cir. 1999). Indeed, the preamble to the final regulations emphasized continuity, specifically noting the drafters' intent to "adopt[ ] the criterion for creditability set forth in" the three leading precedents under section 901. T.D. 7918, 48 Fed. Reg. 46272, 46273 (Oct. 12, 1983).

Certainly, nothing in the preamble or the text of the regulations suggests any change in the treatment of excess profits taxes. The judicial decisions under the new regulations are fully consistent in this respect with prior law. For example, the Tax Court found creditable under the new regulations a British tax on petroleum revenue that was identified by government officials as "an excess profits tax" and that the court found "constitutes an income or excess profits tax in the U.S. sense." *Exxon v. Commissioner*, 113 T.C. 338, 357, 356 (1999). *See also Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 312 (1995) (applying temporary regulations and stating that credit "encompasses foreign income taxes designed to effectively reach *some net gain* or profit") (emphasis added).

2. The Creditability of a Foreign Tax Is Measured by Its Actual Operation and Effect, Not by the Labels Used by the Foreign State

This Court laid down the basic principle for construing the foreign tax credit statute in *Biddle v. Commissioner*, 302 U.S. 573 (1938). The meaning of "income, war profits, and excess-profits taxes" is not determined "by reference to foreign characterizations and classifications of tax legislation." *Id.* at 579. Rather, a court looks to

how these terms are "used in our own revenue laws," and must "ascertain[ ] from an examination of the manner in which the [foreign] tax is laid and collected" whether the foreign tax falls within the language of section 901 "as those terms are used in our own statute." *Id.*

Later court decisions made clear that the labels attached by the foreign state would not govern creditability. In *Bank of America National Trust & Savings Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972), for example, the court explained that "[t]he important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." *See also Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) (the "label and form of the foreign tax is not determinative"). Rather, the courts considered extrinsic evidence of the operation and effect of a tax to determine its similarity to U.S. income taxes. *See, e.g., id.* at 81-87.

As previously noted, the preamble to the 1983 regulations explicitly stated an intent to "adopt[ ] the criterion for creditability set forth in" these cases. T.D. 7918, 48 Fed. Reg. at 46273. And the regulations plainly contemplate an inquiry that looks deeper than the labels attached by the foreign state to its tax – both in repeatedly emphasizing the "predominant character" of the tax and in asking whether it is "likely to reach net gain in the normal circumstances in which it applies." *See, e.g.*, Treas. Reg. § 1.901-2(a)(3)(i). Accordingly, as the Tax Court found, post-regulations cases have consistently "considered evidence of the purpose, design, and operation of the foreign tax in question

in considering creditability," rather than relying on statutory labels. Pet. App. 58; *id.* at 75-77.

B. The Operation and Effect of the U.K. Windfall Tax Is Akin to That of a U.S. Excess Profits Tax

The Tax Court's analysis conformed to both of these basic principles, as the court examined whether the U.K. Windfall Tax was akin to a U.S. excess profits tax by looking to its operation and effect. The Tax Court found that "both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies." *Id.* at 84. Explaining that "our inquiry as to the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits," the court concluded that the tax "did, in fact, 'reach net gain in the normal circumstances in which it applied'" within the meaning of the regulations. *Id.* at 79, 84. The court's conclusion was supported by a voluminous evidentiary record concerning the operation and effect of the U.K. Windfall Tax, as well as the history of its development into the particular form in which it was enacted.

But the court's analysis did not just rely upon extrinsic evidence. The court also analyzed the tax as set forth on the face of the statute and determined that in substance the tax constituted an excess profits tax. *Id.* at 83. The tax rate was applied to a quantity that contained two basic variables – the taxpayer's "initial period profits"

and its "flotation value."[3] Because the flotation value was used to determine what portion of the profits were "normal" and hence not subject to the tax, the tax fell only on a portion of the profits component, just like a traditional excess profits tax. Thus, the Tax Court specifically found that "[t]he design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it." *Id.*

The government argued below that the court had inquired too deeply into the operation and effect of the tax. Instead, the government contended, the court should have restricted its analysis to the face of the U.K. statute and accepted the description there that the two basic variables were "flotation *value*" and "profit-making *value*." Pet. App. 8 (emphasis added); *see also id.* at 71. Since the tax base was defined as "the difference between two imputed values," the government argued, the tax must be treated as a tax on value, not an income tax. *Id.*

The court of appeals did not rest its decision on the use of the word "value" in the U.K. statute. But, even though it paid lip service to the proposition that "classification of a foreign tax

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[3] There was slight variation among the taxpayers with respect to the length of the initial period for which profits were measured. Of the 32 taxpayers subject to the tax, 29 had an initial period of four full financial years (generally 1,461 days), but three others (including one who paid no tax) had shorter periods. *See* Pet. App. 43-44. These minor deviations do not affect the predominant character of the tax and, for purposes of simplicity, we treat the tax in this brief as covering an initial period of four years.

hinges on its economic substance, not its form" (*id.* at 9), the court of appeals ultimately approached the inquiry in a very formalistic way. It erroneously ruled that the outcome was controlled by the precise way in which the foreign legislators described the tax calculation. *See infra* pp. 22-29.

Perhaps blinded by its focus on the tax formula in algebraic terms, the court of appeals did not directly take issue with the Tax Court's findings that the U.K. Windfall Tax operated as an excess profits tax. The court of appeals was remarkably silent on this point, apparently believing that the Tax Court's finding was irrelevant. But the statute indicates that the credit should be available for a foreign tax that operates like a U.S. excess profits tax. Accordingly, before turning to the court of appeals' discussion of the tax calculation, we briefly address why the Tax Court was correct in viewing this tax as an excess profits tax and the government was wrong in arguing that it is a tax on value.

In *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937), this Court addressed in the state tax context the question whether a tax is properly classified as an income tax or as a property tax. The specific issue was whether a state tax on rental income from real property located in another state was barred as equivalent to a tax on the real estate. The Court asked where the tax burden fell, remarking that the "incidence of a tax on income differs from that of a tax on property." *Id.* at 314. In particular, a hallmark of a property tax is that the "property may be taxed although it produces no income." *Id.* An income tax is measured "by the amount of income received over a period of time,"

while a property tax is measured "by the value of the property at a particular date." *Id.*

Evaluated using these criteria, it is apparent that the U.K. Windfall Tax is an income tax, not a tax on value. There was a direct correlation between a change in a company's initial period profits and a change in its tax liability. *See* Pet. App. 61-62. And when a company had no income during the relevant period, its tax liability was zero – an attribute identified in *Graves* as indicative of an income tax, not a property tax. *See* Pet. App. 44, 64-65 (British Energy had no Windfall Tax liability "because of low initial profits"); 300 U.S. at 314.

Other aspects of the tax confirm that the U.K. Windfall Tax was a tax on income, not value. Although the statute termed the profits component of the tax calculation "value in profit-making terms," that component consisted of historical profits, which might not reflect the company's actual value going forward. An obviously better measure of true "value of the property at a particular date" (*id.*) would have been readily available market valuations, but the U.K. Windfall Tax calculation took no account of those. Moreover, the tax fell on the parties who earned excess profits – namely, the companies. It did not fall on the parties who benefitted from the alleged undervaluation at the time of privatization – namely, the original shareholders of the newly privatized companies. Again, this reflects the "incidence of a tax on income," which "differs from that of a tax on property." *Graves*, 300 U.S. at 314. In short, there is no serious basis for disputing the Tax Court's conclusion that the design, operation,

and effect of the U.K. Windfall Tax was that of an excess profits tax.

C. The Government Misapplies the Regulations in Arguing That the U.K. Windfall Tax Fails to Meet the Formal Requirements of the Three-Part Test

As noted, the court of appeals did not dispute the Tax Court's finding that the U.K. Windfall Tax operated like an excess profits tax, with the tax falling on a portion of a company's average annual net income over a four-year period. And there is no basis for disputing that those amounts subjected to the tax – that is, the "initial period profits," which came directly from the companies' book income – satisfied the three-part test of the regulations. The British financial reporting requirements are materially indistinguishable from those in the United States. The amounts were derived from actual gross receipts that had been realized, with deductions for expenses. *See generally Entergy v. Commissioner*, 683 F.3d 233, 236 (5th Cir. 2012).

The government has argued, however, that the U.K. Windfall Tax, as written, nevertheless fails to satisfy the three-part net gain test under the regulations. In this regard, the government argued that actual profits was but one factor in computing what the statute terms "value in profit-making terms," and that the windfall tax "was then imposed on the difference between profit-making value and flotation value." Respondent's C.A. Br. at 31-32. As such, the government contended that the resulting tax base fails the regulatory test. *Id.* In addition, the government argued that the Tax Court erred in analyzing the tax by looking at mathematically equivalent algebraic restatements

instead of the precise form in which the tax calculation is described in the U.K. statute. These contentions threaten the creditability of all excess profits taxes and must be rejected.

1. The Baseline Quantity That Identifies "Normal Profits" Need Not Be Derived from Net Gain

The government argued in the court of appeals that, in the case of an excess profits tax, the portion of net income that is taxed is just "one component of the tax base" and the three-part net gain test must be applied to the "tax base itself." Respondent's C.A. Reply Br. at 5. In so doing, the government failed to acknowledge that the other "component of the tax base" for an excess profits is the quantity used to determine how much of a company's profits are "excess" – here, the "flotation value" of each company – a quantity that typically is not correlated with net income. Accordingly, the government argued, PPL could not show that "the base of the windfall tax was computed in a manner that satisfies the three-part test" because the computation necessarily incorporates the flotation value, which did not reflect net gain. *Id.*; *see also* Respondent's C.A. Br. at 32; Pet. App. 8 (according to the government, the "tax base" is "the difference between two imputed values," and this tax base "fails to meet either the gross receipts or the net income requirement" because neither value represents gross receipts and "the tax base" does not account for recognized expenses); *id.* at 66 ("As a tax imposed on a base equal to the unrealized difference between two defined values, rather than directly on realized gross receipts reduced by

deductible expenses, respondent argues that it necessarily fails to satisfy any of the three tests.").

This proposed approach is illogical. In the government's view, creditability turns on an analysis of the "tax base," the quantity to which the statutory rate of tax is applied. Under the statutory text, a constructed value termed "value in profit-making terms" is reduced by flotation value and the resulting tax liability is 23% of the difference. Flotation value is used to define that portion of the company's profits on which an excess profits tax is *not* imposed. So there is no reason why the "manner" in which flotation value is computed should satisfy the three-part regulatory test, even if determining that value is necessary to determining the taxpayer's ultimate foreign tax liability. Indeed, the IRS rejected precisely this argument in Rev. Rul. 56-51, 1956-1 C.B. 320, 320, stating that an excess profits tax is creditable, even though "reference must be made to the valuation of capital . . . as a basis for computing the excess profits." *See supra* pp. 7-8.

The court of appeals expressed agreement with this argument, even while acknowledging the likely death blow that it would deal to credits for excess profits taxes. *See* Pet. App. 9-10. The court stated that the regulation "expressly defines an excess profits tax as an 'income tax,'" apparently suggesting that the three-part test must be applied to the entire excess profits tax calculation, including determining the quantity that defines how much is "excess." Pet. App. 10-11 n.2. In response to PPL's protest that this approach would disqualify traditional excess profits taxes, the court of appeals stated that PPL's "argument merely

suggests that the regulation misinterprets the statute," and it was too late for PPL to argue that the regulation is invalid. *Id.* at 10 n.2.[4] Ultimately, however, the court of appeals chose not to rest its holding on this analysis, stating that it would "indulge for the sake of argument PPL's contention" that the calculation of flotation value should not be subjected to the three-part test analysis.

In fact, the court of appeals' determination to "indulge" PPL is compelled by the statutory text, not merely by "historical practice." *Cf.* Pet. App. 11 n.2. The statute affords the credit to foreign taxes that operate like U.S. excess profits taxes, but the

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[4] The court's suggestion that PPL should have argued that the regulations conflicted with the statute is only one example of how the court of appeals fundamentally misunderstood the regulations and mistakenly believed that they worked a major change in the law by imposing a more restrictive three-part test. The court also stated that there was "tension" between the text of the regulation and the preamble, and therefore determined to disregard the preamble, when in fact there is no such tension. Pet. App. 6-7 n.1. In support of this proposition, the court pointed to a post-1983-regulations decision that "reached the opposite result" from a pre-regulations decision concerning the operation of the Ontario Mining Tax. *Id.* (citing *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999), and *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982)). But, if anything, these cases contradict the court's premise because it was the later, post-regulations case that upheld the credit. To the extent the contrast between these cases is relevant here, it shows that the 1983 regulations are more "favorable to taxpayers" than the "more restrictive" predecessor regulations. Isenbergh, ¶ 56.2.4 at 56,005-06 & n.27. *See Texasgulf*, 172 F.3d at 216-17 (explaining that the 1983 regulations' explicit recognition of "allowances that effectively compensate for nonrecovery" of expenses makes the credit more readily available in certain cases).

government's approach would threaten the credit for such taxes that were routinely regarded as creditable for decades. The U.K. Windfall Tax is not unique in determining "normal" profits by reference to a quantity that does not reflect net income. Rather, the quantity that defines what profits are "excess" typically is based on a permissible rate of return on capital, and therefore including that quantity in the "tax base" and requiring the manner of computing that base to satisfy a test aimed at "net gain" will necessarily result in denying the credit. The government's position thus would override the consistent prior administrative treatment of excess profits taxes and, indeed, would as a practical matter eliminate excess profits taxes from the foreign tax credit statute.

A regulation that effectively eliminated excess profits taxes from section 901 by applying the net gain test in the manner the government requests would surely be invalid for contradicting the statute. But there is no reason to interpret the existing regulation that way. Contrary to the court of appeals' statement, the regulation does not try to distort reality by "expressly defin[ing] an excess profits tax as an 'income tax.'" Pet. App. 10 n.2. Rather, the language in the regulation is much more reasonably read to provide simply that, when the regulation uses the term "income tax," the same rules apply to the portion of income taxed under an excess profits tax. *See supra* pp. 9-10; *Exxon v. Commissioner*, 113 T.C. 338, 356-59 (1999) (applying regulation's net income test and concluding that the foreign tax "in its predominant character, constitutes a tax in the nature of an

excess profits tax (i.e., an income tax) in the U.S. sense"). In that way, the court can determine whether the foreign tax is calculated to reach "some net gain." Accordingly, the Court should apply the regulatory test only to the portion of PPL's income that is subject to taxation, without addressing how flotation value is determined.

2. The Court of Appeals Erred in Holding That the Creditability of a Foreign Tax Depends on Whether the Computation Set Forth in Foreign Law Multiplies the Tax Base by Another Number Before the Statutory Tax Rate Is Applied

Setting aside flotation value, the court of appeals concluded that the U.K. Windfall Tax fails to satisfy the regulatory test because the precise manner of calculation of the portion of the tax base that specifically incorporates net income runs afoul of a particular nuance in the regulations – namely, an example that illustrates an aspect of the gross receipts rule that is inapplicable to this case. In so holding, the court completely misread the regulations and reached an absurd result that could not possibly have been intended by Congress or by the drafters of the regulations.

a. The Court of Appeals' Reasoning Leads to Absurd Results

As the Tax Court found, the operation of the U.K. Windfall Tax can be summarized in a fairly simple algebraic formula. The tax was imposed on a portion of the company's average annual profits over the initial period of its operation; the profits potentially subject to tax were reduced by the

company's "flotation value." The specific tax base consisted of the profits earned over the relevant period (four years for all but a handful of companies), divided by the length of the period and multiplied by a predetermined "price-to-earnings ratio" set at nine, less flotation value. That quantity was taxed at a 23% rate. The only variable in this tax base was the company's profits. Using "P" to represent those net profits and "FV" to represent "flotation value," the parties stipulated and the courts below agreed that the overall tax formula can be expressed as follows for all but a handful of companies:

$$23\% \times [(P/4 \times 9) - FV]$$

Pet. App. 4, 9, 62-63. Applying basic algebraic simplification, that formula reduces to:

$$51.7\% \times (P - 4/9FV)$$

The latter formula describes a 51.7% tax on a portion of net profits, which the Tax Court held was plainly creditable. The court of appeals did not disagree with that conclusion; there is no conceivable basis for doing so. But the court of appeals held that the algebraic simplification described above was an impermissible "bridge too far." Pet. App. 9. The court identified the "fundamental problem" as follows: "the tax base cannot be initial-period profit alone unless we rewrite the tax rate," which the court found to be prohibited by the regulations. *Id.* Therefore, the court of appeals held, the tax had to be analyzed by applying the regulatory test to the earlier version of the formula listed, as a 23% tax on a quantity that represented 9/4 (or 225%) of net profits. According to the court

of appeals, such a tax plainly fell afoul of the regulatory test.

On its face, the court of appeals' decision is absurd. In substance, a 23% tax on 225% of profits is exactly the same thing as a 51.7% tax on 100% of profits. It is inconceivable that Congress would have wanted the U.S. tax law to treat them differently, and nothing in the statute supports the court of appeals' view. Moreover, the approach taken by the court of appeals would give foreign governments complete leeway to determine whether a tax would be creditable, as they could easily manipulate the form of the tax in the manner that the court of appeals found to be dispositive. The court's ruling thus defeats the longstanding principle that creditability depends upon how a foreign tax conforms to U.S. tax principles.

b. Example 3 of the Gross Receipts Portion of the Regulations Lends No Support Whatsoever to the Court of Appeals' Decision

If there were some ambiguity in how to construe the regulations, the above considerations would counsel against accepting the court of appeals' interpretation. But there is in any event no such ambiguity. The court's decision rests on a complete misunderstanding of the regulations, which in no way support the meaningless distinction drawn by the court.

The court's reasoning is based on a single example in the regulations that illustrates the gross receipts aspect of the three-part test. *See* Pet. App. 12-14 (citing Treas. Reg. § 1.901-2(b)(3)(ii), Ex.

3). This example, which was not presented to or discussed by the Tax Court, is completely irrelevant to a proper analysis of the creditability of the U.K. Windfall Tax.

The gross receipts test states that the tax must be "imposed on the basis of—(A) Gross receipts; or (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3)(i). The U.K. Windfall Tax is based on actual gross receipts under subsection A. Example 3 illustrates the application of subsection B, which allows use in certain circumstances of imputed gross receipts. Thus, as the Fifth Circuit explained in *Entergy*, it should have been immediately apparent to the court of appeals that Example 3 has nothing to do with this case. *See* 683 F.3d at 237-38.

A closer look at Example 3 further illuminates how far astray the court of appeals went in finding it dispositive here. The basic gross receipts test is found in subsection (A); a typical income tax will be based on actual gross receipts. Subsection (B) can be described as a liberalizing provision that recognizes the possibility of foreign taxes that cannot be based on actual gross receipts but are sufficiently like traditional income taxes that they ought to be creditable.

A good example of this is a tax on income from mineral production. When the producer is an integrated mining company, income attributable to production activities alone cannot be measured directly. When the product is sold by the taxpayer after processing, the actual gross receipts from that sale would include income attributable to

processing, not just income from mineral production. Thus, the foreign taxing authority will use a proxy to estimate the gross receipts attributable to production, and the regulation allows for a tax computed in this way to be creditable – if the proxy is accurate.[5]

At the same time, the drafters of the regulations were keenly aware that opening the door to such imputed gross receipts could lead to abuse. A few years earlier, the IRS had reviewed its approach towards certain foreign taxes, including surtaxes imposed on oil companies by Libya and Saudi Arabia. *See* Rev. Rul. 78-63, 1978-1 C.B. 228. Those taxes were based on "posted prices set in excess of actual market price," which allowed the countries to extract additional revenues from the foreign oil companies. *Id.* at 229. The IRS ruled that those taxes did not qualify for the credit because the tax base was "measured from an arbitrarily determined value (the posted price)" and hence was "artificial or fictitious." *Id.* at 230, 232. The ruling explained that keying the tax to this artificially inflated price, rather than actual sales, meant that "the requirement that the tax be imposed on realized income is not satisfied." *Id.* at 230. Thus, to protect against potential abuse, the gross receipts test in the regulation emphasizes

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[5] The Ontario Mining Tax at issue in *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982), is an example of this kind of tax that may well have been within the contemplation of the drafters of the regulations. That tax purported to tax income from mineral production, and the statute provided that the gross revenue from production should be assumed to equal the market value of the output at the mining pit's mouth. *Id.* at 81.

that the imputed value for gross receipts must be "likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3)(i)(B).

Example 3 simply illustrates the application of the fair market value limitation. It posits a situation, like the "posted price" in the Libyan and Saudi Arabian surtax ruling, where the foreign law uses an artificial or fictitious quantity as the basis for the tax. Specifically, the example posits a tax on petroleum extraction income in which "gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted." Treas. Reg. § 1.901-2(b)(3)(ii), Ex. 3. It is tautological that such a tax falls outside the plain language of the gross receipts test. Because it "is *designed* to produce an amount that is greater than the fair market value of actual gross receipts" (*id.* (emphasis added)), it necessarily follows that the "deemed" value is not "likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3)(i)(B).

None of this has anything to do with "rewrit[ing] the tax rate," as the court of appeals found. *See* Pet. App. 9. The hypothetical Example 3 tax fails because the "deemed" value is not a genuine proxy for gross receipts. As government counsel stated to the court of appeals at oral argument, "the reason that creditability is denied [in Example 3] is because the foreign country in imposing the tax is actually assuming that the taxpayer has gross receipts in excess of what the fair market value is." Tr. of Oral Argument at 16,

PPL Corp. v. Commissioner, No. 11-1069 (3d Cir. 2011).

As a simple illustration shows, the tax cannot be trusted to reach net gain if the proxy for gross receipts is artificially inflated. *See id.* ("So the foreign country is starting by taxing a number that is greater than perhaps the actual profits that the taxpayer realized."). Suppose that a taxpayer has expenses equal to its actual gross receipts. Under an income tax regime that applies U.S. principles, its net income (and tax liability) ought to be zero. But in the example 3 situation where gross receipts subject to tax are inflated, that taxpayer will have taxable income and an attendant tax liability. Therefore, the tax does not reach net gain; it taxes something else even though there is no net gain. By contrast, the difference on which the court of appeals rested its decision – between a 23% tax on 225% of profits and a 51.7% tax on 100% of profits – is a difference of form with no practical significance whatsoever. In particular, under either method of doing the calculation, the foreign tax is calculated to reach net gain.

The court of appeals found Example 3 relevant because it mistakenly believed that accepting the Tax Court's analysis would render Example 3 "a nullity." Pet. App. 13. The court's explanation was that "a 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts." *Id.* That is true enough "mathematically," but it completely misses the point because the problem at the root of Example 3 is not cured by restating the tax rate. Example 3 addresses the determination of gross receipts for calculating a tax on net income, but the court's discussion appears to view it as a

direct tax on gross receipts (which is generally not a creditable tax). Inflating gross receipts for an income tax will lead to an inaccurate determination of net income, which is the quantity being taxed. For example, in the illustration above where net income should be zero, the inflated proxy for gross receipts will always incorrectly yield some net income no matter how the tax rate is restated. The reasoning of the Tax Court thus does not in any way undermine the rule illustrated in Example 3.

In short, the court of appeals erred in believing that the Tax Court's analysis of the substance of the tax ran afoul of the regulations in any way.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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December 20, 2012

AMICUS CURIAE BRIEF

BOUND
AND

No. 12-43

IN THE

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,
Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF ENTERGY CORPORATION AND AFFILIATED SUBSIDIARIES AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE* ENTERGY CORPORATION AND AFFILIATED SUBSIDIARIES[1]

Entergy Corporation ("Entergy") is a Delaware corporation headquartered in New Orleans. It is the parent company of an affiliated group of corporations that produce and provide electricity.

In 1997, one of Entergy's subsidiaries was London Electricity plc, a U.K. electric company subject to the U.K. Windfall Tax ("Windfall Tax" or "Tax"). Entergy prevailed in the U.S. Court of Appeals for the Fifth Circuit[2] on the issue presently before this Court: whether the Windfall Tax is a creditable foreign tax under 26 U.S.C. 901. The Solicitor General petitioned for certiorari to review the Fifth Circuit's decision in *Entergy Corp. v. Commissioner*.[3] That petition is being held pending the outcome of this case.

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[1] Pursuant to Supreme Court Rule 37.6, *amicus curiae* Entergy Corporation and affiliated subsidiaries state that no counsel for any party authored this brief in whole or in part and that no entity or person, aside from *amicus curiae* and its counsel, made any monetary contribution toward the preparation or submission of this brief. Petitioner and respondent have consented to the filing of this brief, and letters reflecting their consent have been filed with the Clerk of Court.

[2] 683 F.3d 233 (2012).

[3] Supreme Court No. 12-277.

STATEMENT OF THE CASE

This case involves the creditability of the Windfall Tax. Section 901 of 26 U.S.C. provides a credit against federal income tax for the payment of any income, war profits, or excess profits tax to a foreign country. The Treasury Department regulation implementing the statute confirms that a foreign tax is creditable under Section 901 if its "predominant character" is that of an income, war profits, or excess profits tax "in the U.S. sense." 26 C.F.R. 1.901-2(a)(3). The preamble to the regulations states that the "predominant character" standard explicitly adopts the judicial criteria established in *Bank of America Nat'l Trust & Savings v. United States*, 459 F.2d 513 (Ct. Cl. 1972); *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982); and *Bank of America Nat'l Trust & Savings v. Commissioner*, 61 T.C. 752 (1974), *aff'd*, 538 F.2d 334 (9th Cir. 1976). T.D. 7918, 1983-2 C.B. 113, 114. Under this standard, a foreign tax is creditable if it "reach[es] some net gain in the normal circumstances in which the tax applies. ... The label and form of the foreign tax is not determinative." *Inland Steel,* 677 F.2d at 80.

Before this Court, however, the Commissioner maintains that creditability should be judged *only* by the label and form of the Windfall Tax. That contention is insupportable: the outcome here must be governed by the operation and practical effect of the Tax—which demonstrate that the Tax falls on a

specified portion of taxpayer income. In its brief, petitioner PPL establishes that point persuasively and shows that the Windfall Tax accordingly is creditable as an excess profits tax within the meaning of Section 901.

Amicus Entergy fully endorses the arguments offered by PPL. Rather than repeat those arguments in this brief, Entergy focuses on additional materials that support PPL's conclusion: evidence offered by Entergy at the trial of its companion case; the analysis of the Fifth Circuit in Entergy's appeal, which points up the flaws in the Third Circuit decision now under review; and the history and past judicial treatment of excess profits taxes. These materials leave no doubt that Congress (when it enacted Section 901) and the Treasury Department (when it promulgated the Section 901 regulations) regarded levies like the Windfall Tax to be creditable—and that the Third Circuit's contrary conclusion rests on the misguided approach that the labels and form of a foreign statute govern creditability.

I. Historic Excess Profits Taxes

As generally understood in 1918 (the year the foreign tax credit was enacted), excess profits taxes, war profits taxes, and income taxes were forms of income taxes authorized by the 16th Amendment. Excess profits taxes and war profits taxes were imposed on only a portion of total income, whereas

income taxes were imposed on all income. George E. Holmes, FEDERAL INCOME TAX, WAR-PROFITS AND EXCESS-PROFITS TAXES 136 (Bobbs-Merrill Co. 1920).

At the time, excess profits and war profits taxes were thought of as distinct, although both were imposed on a specified portion of taxpayer profits.[4] Eventually the distinction blurred, and war profits taxes were subsumed within excess profits taxes.[5] The authoritative commentator Kenneth James Curran wrote in 1943, "The customary practice today ... is to use the term 'excess profits tax' to describe any levy that is confined to a segment of a taxpayer's income that is considered excessive, no matter by what standard of measurement it is determined." EXCESS PROFITS TAXATION (American Council on Public Affairs 1943) (App., *infra*, 13a-23a) at 15a-16a.[6]

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[4] *See* Statement of W.G. McAdoo, Treasury Secretary, INCOME, EXCESS PROFITS, AND ESTATE TAXES: HEARINGS BEFORE THE HOUSE COMM. ON WAYS AND MEANS 15 (1918) ("By a war-profits tax we mean a tax upon profits in excess of those realized before the war. By an excess-profits tax we mean a tax upon profits in excess of a given return on capital.").

[5] *See* Holmes, *supra*, at 644 ("The law, however, does not adhere to a clear distinction between war-profits and excess-profits. ...").

[6] This brief cites to four appendices. "App." refers to the appendix attached hereto. "*Entergy* Pet. App." refers to the appendix attached to the Solicitor General's Petition for Certiorari in case No. 12-277. "JA" refers to the Joint Appendix

As the term itself suggests, excess profits taxes measure "normal" profits by a "standard," or floor amount above which profits are considered excessive. The most common standards are the "invested capital" and the "profits" standards. App. 13a. The invested capital standard operates on the assumption that normal profits are measured by a return on the capital invested in the business, expressed as a percentage of invested capital. The excess profits tax is then levied on profits in excess of that percentage. The profits standard measures normal profits by the average profits earned during an earlier "base period." App. 14a.

The first U.S. excess profits taxes, enacted in 1917, shed light on the meaning of "excess profits" as used the next year in Section 901's predecessor. Those taxes used an invested capital standard to measure normal profits. Act of March 3, 1917, ch. 159, §§ 200-207; Act of October 3, 1917, ch. 63, §§ 200-214. The following year, Congress enacted an excess profits tax (using an invested capital standard) and a war profits tax (using an average profits standard with adjustments for changes in invested capital). Revenue Act of 1918, ch. 18, §§ 300-337, 40 Stat. 1057 (1919). Taxpayers were liable for the greater of the excess profits tax or the war profits tax. *Id.*

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accompanying PPL's brief in this case. "Pet. App." refers to the appendix attached to PPL's Petition for Certiorari in this case.

Excess profits taxes enacted for World War II and the Korean War allowed taxpayers to choose between an invested capital or average profits standard to measure normal profits. Second Revenue Act of 1940, Pub. L. No. 801-76, ch. 757, §§ 710-752; Excess Profits Tax Act of 1950, Pub. L. No. 909-81, ch. 1199, §§ 430-472.

II. The Design of the Windfall Tax Shows that the Labour Party Intended to Tax the Excess Profits of the Windfall Companies

Between 1984 and 1996, the United Kingdom privatized more than 50 government-owned companies, many of which were monopolies subject to economic regulation. The government privatized the companies by selling shares to investors at a fixed offering price in a "flotation" (public offering). Pet. App. 24-25.

After flotation, the privatized companies that would eventually be subject to the Windfall Tax (the "Windfall Companies") were considerably more efficient and profitable than expected. Substantial profits led to unexpectedly high dividends, executive compensation, and share price increases, which fueled public outcry that shareholders and executives of the privatized companies had profited unduly to the detriment of the U.K. fisc and consumers. Pet. App. 29-30. According to Geoffrey Robinson, a senior Treasury Minister who drafted the Windfall Tax, "People felt that too many bureaucrats, some of

whom had never taken a risk in their lives and had not shown much managerial talent, had become overnight millionaires thanks to a botched government privatization process." *Entergy Corp. v. Comm'r*, T.C. Memo 2010-197 (2010) Ex. ("Ex.") 27-R at 68.

Beginning in the early 1990's, the Labour Party stated publicly that, in order to finance social programs, it would impose a windfall tax on the excess profits of the privatized companies. "[B]y 1993, ... the shadow Chancellor [ ] put forward a program whereby we would tax those excess profits and use the funds to finance public works in the name of a youth employment program." JA 499-500. By 1994, the idea of an excess profits tax had become a principal feature of the Labour Party's speeches and programs leading up to the 1997 Parliamentary election. Pet. App. 31.

Drafting the Windfall Tax posed a complex task. Ex. 27-R at 66-67. There were over 150 privatized companies which could have been judged to have earned excess profits. Ex. 27-R at 70. Moreover, the companies were in different industries, had been privatized at different times, and had different accounting methods. Ex. 27-R at 67.

To get the Windfall Tax enacted by Parliament, it was imperative that it define a specific class of companies and tax each on the same basis.

Otherwise, it would be classified as a "hybrid bill." Ex. 27-R at 79; Ex. 67-P (App., *infra*, 1a-8a) at 1a. Because hybrid bills disproportionately burden similarly situated interests, they are subject to a longer parliamentary process and are more vulnerable to parliamentary challenge. App. 1a-2a.

Additionally, a number of Windfall Companies threatened to challenge the legality of the Windfall Tax. Ex. 27-R at 75. While the outcome of the lawsuits was uncertain, a tax that discriminated among the Windfall Companies was certain to be stuck in protracted litigation. The Labour Party was also concerned that if the tax were hastily drafted, it would be subject to an endless stream of opposition amendments, and the Labour Party would have to make significant concessions to get the bill passed. Ex. 27-R at 67. Before the tax was even drafted, newspapers were predicting that the Windfall Tax would be subject to "a legal quagmire and huge parliamentary delays." Ex. 27-R at 80.

To expedite enactment of the Windfall Tax, the Labour Party retained Arthur Andersen in 1996. Pet. App. 31-32. Gordon Brown, then the Labour Party's Shadow Chancellor of the Exchequer, instructed Arthur Andersen to draft proposals for the imposition of a tax on the privatized companies' excess profits that would meet Parliamentary requirements, would be sustainable by the companies, and would not conflict with U.K. or European Union law. JA 502.

Arthur Andersen proposed six options. Three of the proposals were a tax on turnover (gross revenue), on assets, and on profits. All three were rejected. JA 505-506.

The fourth proposal was a traditional excess profits tax, which used pre-privatization profits as the standard above which the excess would be calculated. JA 512. However, it was not workable because British Gas, the utility that ultimately paid the single largest amount under the Windfall Tax, had a decrease in profits after privatization. *Entergy*, 683 F.3d 233, C.A. R.E. ("R.E.") Tab H, Scheds. 4A-4B; JA 512. Thus, an excess profits tax that used a traditional "historic profits" standard would have discriminated among the Windfall Companies. The Labour Party was forced to reject this option because it would have been vulnerable to legal challenge and would have been classified as a hybrid bill, subject to lengthy Parliamentary review and delays. JA 509-510; App. 1a-2a.

A fifth proposal was a tax on excess shareholder returns. JA 507. However, it faced the same problems as an excess profits tax using an "historic profits" standard. In this case, British Telecommunications showed decreased post-privatization shareholder returns and would have been excluded. JA 509. Also, a tax on shareholder returns would have violated the Labour Party's promise not to raise personal tax rates, would not have taxed shareholders who profited from the

flotation but had already sold their stock, and would not have reached overseas shareholders. Therefore, this proposal was also rejected. JA 507.

As a solution to these problems, Arthur Andersen devised an excess profits tax (the Windfall Tax) using a percentage of flotation value[7] as the standard rather than prior period profits. It was adopted because it could be applied to all of the Windfall Companies in the same way and at the same rate. Thus, the Windfall Tax avoided the vulnerabilities to legal challenge and Parliamentary delay posed by the other options. The Tax could also be borne without economically damaging the companies and would reliably yield the amount of revenue necessary to fund Labour's social programs. JA 509-510.

The Windfall Tax was enacted by the U.K. Finance (No.2) Act of 1997 (the "Windfall Tax Act" or "Act"). Ex. 18-J. Gordon Brown, by then Chancellor of the Exchequer, described the Tax as a "one-off windfall tax on the excess profits of the privatized utilities." Ex. 15-P, ¶ 188. The United Kingdom's Board of Inland Revenue described it as a tax on excess profits. Ex. 17-P, ¶ 41. There is no mystery why this language was used to describe the Windfall Tax: as PPL shows in its brief and as we

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[7] Flotation value equaled the product of the per-share flotation price and the number of ordinary shares issued in the flotation. Pet. App. 139-140.

demonstrate below, the amount of tax paid is measured by the size of a specified portion of taxpayer profits.

III. The Windfall Tax Had the Effect of an Excess Profits Tax

In the Tax Court, Entergy and PPL submitted extensive evidence demonstrating that the Windfall Tax had the effect of an excess profits tax. Both taxpayers offered algebraic formulations of the Windfall Tax calculation to show that the Tax was the equivalent of a 51.71 percent tax imposed on profits in excess of 4/9ths of flotation value.[8]

Entergy's U.K. accounting expert, Michael Taub, testified that the aggregate tax imposed on the 31 Windfall Companies equaled 20.27 percent of the aggregate Initial Period Profits.[9] R.E. Tab H, Scheds. 4A-4B. No Windfall Company had a Windfall Tax liability in excess of Initial Period Profits. Pet. App. 43.

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[8] The Tax Court described the Tax as a 51.71% tax on profits in excess of 44.47% of flotation value. Pet. App. 63. That equation reflects the inclusion of the extra leap year day, which makes the ratio used to determine average annual profits slightly more than 4/9. Omitting the extra day for the leap year results in the 51.75 percent tax rate.

[9] The Windfall Tax Act defined "Initial Period Profits" as a company's after-tax profits earned during its four financial years immediately following flotation. Pet. App. 36-37.

Entergy's U.S. accounting expert, Raymond Ball, testified that "[t]he effect of this tax is that, for a utility paying the tax, every £1 increase or decrease in profit, in any one of the four years [of the windfall period], would increase or decrease the tax payable ... by £0.5175." Report of Raymond Ball, Ex. 69-P ¶15. The use of flotation value in the Windfall Tax equation merely set the threshold amount above which profits were taxed. "The choice of this particular threshold presumably reflects the political circumstances that triggered the enactment of this tax, but does not alter the conclusion that it is a tax imposed on the company's net income." Ex. 69-P ¶ 26.

Additionally, profit as calculated in the United Kingdom is of the same nature as net income as calculated in the United States. Ex. 69-P ¶ 28. "Under the U.K. Windfall Tax, the profit on which the tax is based is realized gross receipts net of associated expenses. ..." Ex. 69-P ¶ 32. Thus, Ball testified that "[i]t is net income alone that is necessary for [the Windfall Tax] to be payable." Ex. 69-P ¶ 50.

PPL's accounting experts echoed the testimony of Entergy's accounting experts. Mark Ballamy, PPL's U.K. accounting expert, testified that "the windfall tax fell on the excess profits of the Windfall Tax Companies during their initial periods and that all of these profits represented realized profits." Edward Maydew, PPL's U.S. accounting expert,

testified that in substance, the Windfall Tax was a tax on profits similar to prior U.S. and U.K. excess profits taxes. Pet. App. 59.

At trial, Entergy's counsel elicited statements from the government's U.K. tax expert, Philip Baker, demonstrating that the Windfall Tax operated as an excess profits tax as opposed to a tax on excess value. According to the government's expert, the Windfall Tax taxed profits in excess of a floor amount; it did not tax corporate value. Specifically, the government's expert testified to the operation of the Windfall Tax in four hypotheticals:

1. Windfall Tax liability could arise only if a company earned sufficient profits during the initial period to cause the value in profit-making terms[10] to exceed flotation value;

2. Once a company earned profits sufficient to exceed the flotation value threshold, Windfall Tax liability increased in the same proportion as profits increased;

3. A company with no Initial Period Profits incurred no Windfall Tax liability regardless of how much its stock value increased; and

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[10] "Value in profit-making terms" was defined as nine times average annual profit earned during a company's four financial years immediately following flotation. Pet. App. 139.

4. A company with sufficient profits would incur Windfall Tax liability regardless of how much its stock value deteriorated. R.E. Tab D, Tr. at 219-222 (App., *infra*, 9a-12a).

IV. Judicial Treatment of the *Entergy* Case

As PPL explains in its brief (at 15-16), the Tax Court ruled for both PPL and Entergy, holding that the Windfall Tax is a creditable tax on excess profits. On the government's appeal, the Third Circuit reversed as to PPL in the decision under review. *See* Pet. Br. at 16-19. But the Fifth Circuit affirmed as to Entergy, expressly rejecting the Third Circuit's analysis in this case. *See* No.12-277, *Commissioner v. Entergy Corp.*, Pet. App. ("*Entergy* Pet App.") 1a-13a.

Writing for the Fifth Circuit panel, Chief Judge Jones began by finding that "[t]he case law from which 26 C.F.R. 1.901-2 is derived refutes the Commissioner's assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax's 'predominant character.'" *Entergy* Pet. App. 6a. Viewing the Tax "in practical terms," the Fifth Circuit went on to hold that it "clearly satisfies the realization and net income requirements" of 26 C.F.R. 1.901-2. *Entergy* Pet. App. 7a. Regarding the first of these requirements, the court found that the Tax "is based on revenues from the ordinary operation of the utilities that accrued long before the design and

implementation of the tax"; "indeed, the Labour Party accurately estimated the amount the Windfall Tax would raise, as the earnings of each of the utilities were publicly available when the Labour Party drafted the tax." *Entergy* Pet. App. 7a. As to the net income requirement, "the tax *only* reached—and only *could* reach—utilities that realized a profit in the relevant period." *Entergy* Pet. App. 7a.

The Fifth Circuit then turned to the regulatory gross receipts requirement. As to this, the court explained:

> [T]he tax's history and practical operation were to 'claw back' a substantial portion of privatized utilities' 'excess profits' in light of their sale value. These initial profits were the difference between the utilities' income from all sources less their business expenses—in other words, gross receipts less expenses from those receipts, or net income. The tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor.

Entergy Pet. App. 7a-8a. That "Parliament termed this aggregated but entirely profit-driven figure a 'profit-making value,'" the court continued, "must not obscure the history and actual effect of the tax, that is, its predominant character." *Entergy* Pet. App. 8a.

Having reached this conclusion, the Fifth Circuit specifically rejected the Third Circuit's contrary analysis in this case as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Entergy* Pet. App. 9a. In particular, the Fifth Circuit noted that the Third Circuit's analysis was premised on a misunderstanding of the regulatory gross receipts requirement and accompanying illustrations. As the Fifth Circuit explained, "[t]he gross receipts requirement ... serves as one mechanism to prevent foreign nations from 'soaking up' American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount greater than the business's actual gross receipts." *Entergy* Pet. App. 9a. But the Windfall Tax does not rest on an "imputed amount" of gross receipts, "nor indeed on any imputation." *Entergy* Pet. App. 11a. "Instead, the Windfall Tax begins by taking 23% of the daily average of profit based on *actual gross receipts*, multiplied by a statutory constant of nine (deemed a 'price-to-earnings ratio'), less each company's flotation value. ... There was no need to calculate imputed gross receipts; gross receipts were actually known." *Entergy* Pet. App. 11a.

Moreover, the Fifth Circuit added, "the Third Circuit opinion seems to overlook that a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts." *Entergy* Pet. App. 11a. Thus, "London Electricity's profit for [the] purpose of

the Windfall Tax was calculated by computing gross receipts less operating expenses. The Windfall Tax was designed to reach a *subset* of this left-over amount by beginning with an amount predicated on *actual gross receipts* minus flotation value." *Entergy* Pet. App 11a-12a. The Third Circuit's refusal to take account of this reality, the Fifth Circuit concluded, is the "sort of formalism" that cannot be squared with the regulation's "predominant character standard." *Entergy* Pet. App 12a.

INTRODUCTION AND SUMMARY OF ARGUMENT

It is a fundamental principle of U.S. tax law that "tax classifications ... turn on the objective economic realities." *Boulware v. United States*, 552 U.S. 421, 429 (2008). The Commissioner cannot deny that this doctrine of "substance over form" governs the application of Section 901, as this Court expressly held in *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938), when it ruled that creditability turns on "the manner in which [the] tax is laid and collected." That should be the end of this case. Basic algebra establishes that the Windfall Tax falls on a specified portion of realized taxpayer income—that portion expressly described by the Chancellor of the Exchequer, the U.K. Board of Inland Revenue, and the Tax's drafters as "excess profits." Such a levy would seem to be the very model of an "excess profits tax."

In rejecting this common-sense conclusion, the Commissioner argues and the Third Circuit held that the labels used by a foreign tax statute must trump the statute's real-world operation. The Windfall Tax therefore is not creditable, they say, because the formula used to set the tax rate does not, in so many words, use the terminology of "excess profits." But this myopic focus on labels, which would work a radical departure from the settled understanding of Section 901, is wrong. As the Fifth Circuit demonstrated in Entergy's case, the reality is that the amount produced as the tax base by the Windfall tax formula is, *in every case*, a "*subset*" of "gross receipts less operating expenses." *Entergy* Pet. App. 11a-12a. A tax imposed on that subset must be an "excess profits tax." Indeed, in this respect the Windfall Tax is functionally indistinguishable from historic excess profits taxes, imposed both by the United States and by foreign nations, which predated and shaped the understanding of the term "excess profits tax" as it is used in Section 901 and the implementing regulation.

No other court has ever adopted the Third Circuit's approach to Section 901, which disregards the real operation of the tax at issue. It departs from the intent of Congress and the manifest meaning of the governing regulation. The Third Circuit's decision accordingly should be set aside.

ARGUMENT

Under 26 U.S.C. 901, U.S. taxpayers are entitled to credit the payment of any foreign income, war profits, or excess profits against their federal income tax liability. The principles of law governing creditability of a foreign tax were forged by an unbroken line of cases beginning with *Biddle v. Commissioner* and embodied in 26 C.F.R. 1.901-2 since 1983. Central among these principles is that creditability depends on the substance of the foreign tax law, i.e., its operation and effect, as opposed to the labels used in the foreign law.

Despite this wealth of authority, the Commissioner argues that creditability of a foreign tax is determined exclusively by the literal text of the foreign tax statute, and that consideration of other evidence is legal error. Not a single case supports the Commissioner's position, and while the Third Circuit in *PPL* correctly stated the applicable principle, it failed to apply it.

I. The Windfall Tax Has the Predominant Character of an Excess Profits Tax

The Windfall Tax is a creditable excess profits tax. Under C.F.R. 1.901-2, the "predominant character" of a foreign tax is that of an income, war profits, or excess profits tax in the U.S. sense if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. 1.901-

2(a)(1)(ii); 1.901-2(a)(3). To be creditable, a foreign tax, judged on the basis of its predominant character, must satisfy each of the three tests in 26 C.F.R. 1.901-2(b).[11]

Since the relevant Section 901 regulation was promulgated in 1983, every decision testing creditability has examined the operation and effect of the foreign tax to determine its predominant character. As the Fifth Circuit acknowledged, no decision has determined creditability exclusively, or even chiefly, by the text of the foreign statute.[12] That reality demonstrates a judicial consensus on the proper application of Section 901—a consensus wholly inconsistent with the Commissioner's approach. Adopting the Commissioner's proposed rule would work a disruptive and dramatic departure

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[11] A foreign tax, judged on the basis of its predominant character, is creditable if (i) it is imposed subsequent to the occurrence of events that would result in the realization of income under the Internal Revenue Code (the "realization test"), (ii) it is imposed on the basis of gross receipts or gross receipts computed under a method that does not exceed fair market value (the "gross receipts test"), and (iii) the base of the tax is computed to permit recovery of significant costs and expenses attributable to such gross receipts (the "net income test"). 26 C.F.R. 1.901-2(b)(2) – (4).

[12] *See Entergy* Pet. App. 6a ("The case law from which 26 C.F.R. § 1.901-2 is derived refutes the Commissioner's assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax's 'predominant character.'").

from the uniform current understanding of the statute.

In *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995), the Tax Court evaluated a Norwegian petroleum tax under the temporary Section 901 regulation preceding the current regulation. The court received evidence of Norway's purpose in designing the tax and how it actually operated. *Id.* at 291-292, 301-302. Indeed, the Commissioner offered evidence about the design of the tax[13] and expert testimony that the tax base did not approximate gross receipts.[14] Although the text of the petroleum tax statute did not satisfy the gross receipts test, the court analyzed quantitative data and found that the base of the tax, in effect, approximated gross receipts. *Id.* at 312. Therefore, the court found the petroleum tax creditable as an excess profits tax under Section 901. *Id.* at 316.

In *Texasgulf Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999), the Second Circuit judged the creditability of the Ontario Mining Tax ("OMT"). The OMT statute excluded deductions for investment

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[13] *See Phillips Petroleum*, 104 T.C. at 292 ("Respondent's allegations that Norway sought a desired or prescribed level of compensation through enactment of the PTA was drawn from comments made by a group in committee recommendations before the [Norwegian Legislature]. ...").

[14] *See id.* at 302 ("In the case at bar, we received testimony and expert reports from three expert witnesses: petitioners put forth two experts ... respondent one expert, Peter R. Odell.").

interest, cost depletion, and royalties paid and instead allowed a deduction for a fixed "processing allowance." *Id.* at 212. The court reviewed empirical evidence to determine how the OMT operated with respect to the entire industry. *Id.* at 215. Because the processing allowance exceeded nonrecoverable expenses for nearly 85 percent of taxpayers, the court found that the processing allowance effectively compensated for nonrecoverable expenses and accordingly held that the OMT reached net gain and was creditable under Section 901. *Id.* at 215-217.

In *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), *acq. in result*, I.R.B. 2001-31, the Tax Court evaluated the creditability of taxes imposed pursuant to the U.K. Petroleum Revenue Act ("PRT"). The PRT did not allow a deduction for interest expenses. *Id.* at 346. Both the Commissioner and Exxon offered testimony from U.K. government officials regarding the purpose of the PRT, expert testimony as to how the PRT operated, and data showing how the PRT affected taxpayers. *Id.* at 342, 348, 354, 357.[15] After evaluating the evidence, the court found

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[15] Additionally, in *Exxon*, the Commissioner argued that it was appropriate to use quantitative data to analyze the creditability of the PRT. 113 T.C. at 359. Although it has no precedential value, the Commissioner's Action on Decision in the *Exxon* case is flatly inconsistent with his current argument. In the AOD, the Commissioner stated, "While we generally believe that quantitative data should not be used exclusively to establish whether the net income requirement is satisfied, we agree that

that the PRT provided several allowances that effectively compensated for the disallowed interest expenses. *Id.* at 357. Thus, the court held the PRT to be a creditable excess profits tax under Section 901. *Id.* at 359-60.

In the Tax Court, Entergy and PPL offered extensive evidence of the operation and effect of the Windfall Tax. Both taxpayers presented witnesses and documents demonstrating that the unquestioned purpose and effect of the Windfall Tax were to tax the excess profits of the privatized companies. *See, e.g.,* Pet. App. 58-59. They showed that the algebraic restatement of the Windfall Tax formula proved that the Windfall Tax was a tax on profits above a floor. *See, e.g.,* Pet. App. 62-63. They submitted quantitative data confirming that the Windfall Tax operated as an excess profits tax with respect to each taxpayer individually and all of the taxpayers combined. *See, e.g.,* Pet. App. 59, 82-83.

The Commissioner's own witness testified that the Windfall Tax operated as an excess profits tax, not as a tax on company value. He testified that:

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the exclusive use of such data may be appropriate in situations involving specialized taxes that apply to a limited number of taxpayers, such as the PRT." AOD CC-2001-04 (Jul. 30, 2001). The Windfall Tax, in the instant case, was a specialized tax that applied to a limited number of taxpayers—and here, quantitative data (that is, data demonstrating the actual relation of the tax to taxpayer profits) show that the Windfall Tax *is* a tax on excess profits.

(i) Windfall Tax liability could arise only if there were sufficient profits during the initial period to cause the value in profit-making terms to exceed flotation value; (ii) once the flotation value threshold was exceeded, Windfall Tax liability increased in the same proportion as profits increased; (iii) a company with no Initial Period Profits incurred no Windfall Tax liability regardless of how much its stock value increased; and (iv) a company with sufficient profits would incur Windfall Tax liability regardless of how much its stock value deteriorated. App. 9a-12a.

The Fifth Circuit reviewed the Tax Court's findings and was "persuaded by the Tax Court's astute observations as to the Windfall Tax's predominant character: the tax's history and practical operation were to 'claw back' a substantial portion of privatized utilities' 'excess profits' in light of their sale value." *Entergy* Pet. App. 7a-8a. The algebraic reformulation of the Windfall Tax, the Fifth Circuit continued, demonstrated conclusively that "[t]he tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor." *Entergy* Pet. App. 8a.

There can be no question that under 26 U.S.C. 901, an excess profits tax is creditable. Several decisions and revenue rulings, which predate promulgation of the Section 901 regulations and therefore shed light on their intended operation, either assumed or concluded that foreign excess

profits taxes were creditable *See H.H. Robertson Co. v. Comm'r*, 176 F.2d 704, 707 (3d Cir. 1949) (conceding that the U.K. World War II Excess Profits Tax was creditable); *Ethyl Corp. v. United States*, 75 F. Supp. 461, 465 (Ct. Cl. 1948) (assuming that the U.K. World War II Excess Profits Tax was creditable); *Columbian Carbon Co. v. Comm'r*, 25 BTA 456, 474 (1932) (conceding that the U.K. World War I Excess Profits Tax was creditable), *acq.*, 1932-1 C.B. 2; Rev. Rul. 68-318, 1968-1 C.B. 342 (finding creditable an Italian tax on profits in excess of a percentage of capital); Rev. Rul. 56-51, 1956-1 C.B. 320 (finding creditable a Cuban tax on profits in excess of a percentage of capital); Rev. Rul. 74-435, 1974-2 C.B. 204 (finding creditable a Swiss Cantonal tax imposed at variable rates on multi-year profits).

The Windfall Tax bore the hallmarks of previous excess profits taxes enacted in both the United States and United Kingdom. A percentage return on flotation value served the function of an invested capital standard. Once that standard was exceeded, every additional £1 in profit resulted in an additional £0.5175 of tax. Ex. 69-P ¶15. Very notably, the Commissioner has not offered any principled ground on which the Windfall Tax can be distinguished from traditional, and unquestioned, excess profits taxes using an invested capital standard. Therefore, the Tax Court and the Fifth Circuit correctly held that the Windfall Tax was a creditable excess profits tax under 26 U.S.C. 901.

II. The Third Circuit's Rigid Textual Analysis Betrays the Case Law and Misconstrues the Regulation

The fundamental error committed by the Third Circuit, as argued persuasively in PPL's brief, was its insistence that creditability of the Windfall Tax could be judged only by the wording of the statute. In this, the Third Circuit was plainly at odds with the pre-1983 case law on which 26 C.F.R. 1.901-2 is premised, the text of 26 C.F.R. 1.901-2, and the post-1983 decisions interpreting 26 C.F.R. 1.901-2, including the Tax Court's and Fifth Circuit's decisions in *Entergy*. The decisions in *Phillips*, *Texasgulf*, *Exxon*, and now *Entergy* make clear that legislative intent and empirical evidence of how a foreign tax actually affects taxpayers are part of the relevant inquiry into creditability.

Moreover, the Third Circuit erroneously and illogically believed that an entirely inapposite example in the regulation foreclosed the use of simple algebra to factor out the 9/4ths multiple in the Windfall Tax. Alone in its reasoning, the Third Circuit could not tolerate a tax base that had the appearance of taxing more than 100 percent of profits. Through simple algebra, the mirage dissolved and exposed the substance of the Windfall Tax as a traditional excess profits tax. This Court would have to ignore the entire body of foreign tax credit jurisprudence to find that a restatement of the Windfall Tax into a 51.71 percent tax on profits in

excess of a fraction of flotation value must be blocked from view. The Fifth Circuit would not go there, and neither should this Court.

Had the Third Circuit examined the reformulation, it would have seen that Initial Period Profits exceeded the restated tax base for every company. Furthermore, the Third Circuit ignored evidence demonstrating that the Windfall Tax reached net gain. It failed to even acknowledge that the aggregate tax burden of the 31 companies equaled 20.27 percent of the aggregate Initial Period Profits,[16] or that no Windfall Company had a Windfall Tax liability in excess of its Initial Period Profits.[17]

The Third Circuit also made no serious effort to explain why the Windfall Tax is not, in reality, a tax on excess profits. To the contrary, one implication of the court's reasoning is that an excess profits tax can never be creditable, a position that Congress did not adopt in Section 901 and the government has never advanced.

Such logic suggests that a tax's predominant character can be revealed only by the tax base as set forth in the foreign taxing statute.[18] According to the

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[16] R.E. Tab H, Scheds. 4A-4B.

[17] Pet. App. 82-83.

[18] *See* Pet. App. 9 ("In our view, PPL's formulation of the substance of the U.K. windfall tax is a bridge too far. No matter how many of PPL's proposed simplifications we may

Third Circuit, if the Windfall Tax had the predominant character of a tax on profits, profits would be the only variable in the tax base.[19] Such reasoning would deny creditability if the tax base includes variables besides profits. However, that approach reads the concept of "excess" profits out of the statute altogether.

The court is simply wrong. Its reasoning implies a lack of understanding of how an excess profits tax functions. Excess profits taxes require a variable in the tax base besides profits to serve as a floor over which "excess" profits are derived. The Windfall Tax used a rate of return on flotation value as that floor.

There is absolutely no doubt that 26 C.F.R. 1.901-2 did not, and could not, deny creditability of excess profits taxes simply because the base of the tax is profits above a floor, as opposed to total profits. A regulation to that effect would flatly contravene the language of 26 U.S.C. 901. With all due respect to the Third Circuit, that it could contemplate such an astonishing possibility reveals how confused it

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accept, we return to a fundamental problem: the tax base cannot be initial-period profit alone unless we rewrite the tax rate.").

[19] *See* Pet. App. 9 ("Were this a tax on initial-period profit, as PPL contends that it is in substance, the tax base would simply be P [for profit] so that we could express the tax thus: Tax = 23% x P.").

was by the government's insistence on rigid textualism.

The Third Circuit's refusal to consider the evidence led to a result that cannot be squared with 26 C.F.R. 1.901-2. The predominant character standard demands more. Under 26 C.F.R. 1.901-2, the Third Circuit was required to consider the design, operation, and effect of the Windfall Tax. Because the totality of the evidence demonstrates that the Windfall Tax is the equivalent of a U.S. excess profits tax satisfying each of the three tests in 26 CFR 1.901-2, this Court should find that it is creditable.

CONCLUSION

For the foregoing reasons, the decision of the Third Circuit should be reversed.

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Appendix A

EXCERPT FROM THE EXPERT REPORT OF GEOFFREY ROBINSON, TAX COURT NO. 25132-06, EXHIBIT 67-P

Appendix 1

Hybrid Bills House of Commons Information Office, Factsheet L5, Legislative Series. Revised February 2005.

* * * *

The windfall tax (Finance (No.2) Bill) is not a Hybrid Bill

For the windfall tax (Finance (No.2) Bill), it was essential to ensure that a specific class of companies was defined and that all companies within it were treated on exactly the same basis. If this was not the case, the Bill would be categorised as hybrid and subject to the 'examination' procedure set out in the attached note; more importantly it would not be a Money Bill enjoying the rights to raise and collect taxes.

* * * *

Introduction

A hybrid bill has characteristics of both a public bill and a private bill. Although of general interest, the

content of the bill would significantly affect the interests of certain individuals or organisations. The bill's progress through parliament therefore includes elements of both the public bill and private bill procedures.

Speaker Hylton-Foster described a hybrid bill as "*a public bill which affects a particular private interest in a manner different from the private interests of other persons or bodies of the same category or class*".

Hybrid bills may be introduced by the Government or by a backbencher. These bills are introduced only rarely, the last occasion before the current *Crossrail Bill* being the *Channel Tunnel Rail Link Bill* introduced in 1994.

Examination

It is not always clear whether a bill should be introduced through the public, private or hybrid bill procedure. Every public bill is examined in the Department of the Clerk of the House before second reading for its compliance with the House's rules. In determining this they take into account the practice and precedents of many years. If the Clerks consider that private interests may be affected, the House will order the bill to be considered by the Examiners of Petitions for private bills. If they find that any standing orders for private business apply to the bill it is treated as a Hybrid, if the Standing Orders do

not apply then the bill proceeds as a public bill. Once the bill has been referred to the Examiners it appears on the Order Paper with a note 'to be reported on by the Examiners'. Second reading cannot take place until the Examiners report. However, in 1976, the House approved a motion to set aside any application to the *Aircraft & Shipbuilding Industries Bill* (a Government bill) of the Private Business Standing Orders.

Bills brought in by the Government (or a backbencher) which propose to undertake works of national importance, but in a local area, have usually been hybrid. Examples include the *Croydon Aerodrome Extension Bill* of 1924-25, the *British Museum Bill* of 1962-63, the *Maplin Development Bill* of 1972-73 and the *Channel Tunnel Bills* in the 1970s and 1980s. A list of all hybrid bills introduced since the 1985-86 session of Parliament is given in the Appendix on page 5.

Other examples of bills which have been proceeded with as hybrids are the *Port of London Bills* 1903 and 1908, the *London Passenger Transport Bill* in 1931, the *Bank of England Bill* in 1945 and the *Transport (London) Bill* of 1968-69.

Bills relating to London have sometimes been hybrid, but in recent years most major bills relating to the capital have been considered as public bills, e.g. the *Greater London Authority (Referendum) Bill* in 1998 and *Greater London Authority Bill* in 1999. Bills

relating to the City of London have usually been private but occasionally hybrid.

Private Members Bills

Private Members may introduce a public bill that the Examiners decide is hybrid, because it is to all intents and purposes a private bill. Such a bill has little chance of becoming law, but a political point will have been made. Examples of such bills are the *Epsom & Walton Downs Regulation (Amendment) Bill* of 1952-53 and the *West Midlands County Council (Abolition) Bill* in 1981-82.

Proceedings on the bill

Preliminary proceedings

A Minister or other Member in charge of a Public bill should be aware at an early stage that it could contain elements of a Hybrid bill. In the case of a Government bill, the Parliamentary draftsmen or Department concerned will almost certainly have pointed this out: steps will have been taken to ensure compliance with Standing Orders (with regard, for example, to advertisements, the drawing up of any necessary plans, etc). Where the Examiners find that the bill has not complied with Standing Orders, it is referred to the Standing Orders Committee (as under Private bill procedure: see Factsheet L4). If this Committee decides that the bill should not proceed,

the promoters of the bill usually abide by this decision.

Second reading

The procedure for second reading of a hybrid bill is the same as for a public bill. After second reading, in order to enable anyone specially and directly affected by the bill to make their case against it, the bill is committed to a select committee, normally made up partly of members chosen by the House and of others chosen by the Committee of Selection; the *Channel Tunnel Bill* in 1985-86 however, was sent to a Committee of nine Members, wholly chosen by the Committee of Selection. The motion to refer the bill to a select committee normally also sets down the requirements for the receipt of petitions against the bill.

Petitions

Any individuals or organisations that oppose the bill can submit petitions against it. The petitions have to be deposited within a stipulated time in the Private Bill Office and must conform to the rules for petitions against private bills.

If the promoter of a bill challenges the status (*locus standi*) of a petitioner, the select committee itself determines who may and who may not be heard and on which sections of the bill. Decisions of the Court of

Referees, who decide similar cases relating to private bills, are binding on the Committee.

Proceedings if no Petitions are Deposited

If no petitions are deposited against the bill within the stipulated time, the bill will be recommitted to a standing committee or committee of the whole House, who will then consider it in the same way as a public bill.

Select Committee

If petitions are received, the select committee will meet and consider the bill in very much the same way as a private bill committee would (see Factsheet L4). However, there are certain differences; in particular, that the promoters do not need to establish the need for the bill since the House has already put on record its approval of the principle of the bill at second reading.

First the petitioners make their case, calling witnesses if necessary. Witnesses are normally examined on oath. When the opponents of the bill have completed their case, and the promoters have been heard in reply, the committee considers the clauses of the bill, reporting it to the House with or without amendment. If the committee wishes to communicate its view on the subject matter of the bill, or if the promoters no longer wish the bill to proceed, the committee may make a special report to the House.

Later Stages

The bill, once reported, is normally re-committed to a committee of the whole House or to a standing committee. Report stage and third reading take the same form as all other public bills. The bill is then sent to the House of Lords where there is a further opportunity for objectors to petition and to appear before a select committee.

Carry-Over between Sessions

As with private bills, the House has, when necessary, considered motions to suspend hybrid bills from one session to another: the *Channel Tunnel Rail Link Bill* was suspended twice. When a General Election has been called, motions have also been considered to allow hybrid bills to recommence at the point they had reached before the election. Motions of these kinds may, of course, be opposed and negatived; in which case the bill would fail, or have to start all over again.

Tracking the progress of hybrid bills

Hybrid bills appear in the "Public bills before Parliament" section of the *Weekly Information Bulletin*, with HYBRID in brackets after the title. These words do not form part of the official title of the bill.

Royal Assent

When both Houses have approved a Hybrid bill, it receives Royal Assent in exactly the same way as a public bill. These Acts are numbered in the Public and General Acts series.

Appendix B

EXCERPT FROM THE CROSS EXAMINATION OF PHILIP BAKER, *ENTERGY CORP. V. COMM'R*, TAX COURT NO. 25132-06, TR. AT 219-222 (APRIL 8, 2008)

Q No. It's not necessary for where I'm going, if you don't mind. Your counsel can explore the rest of the paragraph, but I'm focused on those two sentences, and I would like to explore them with you with some hypotheticals.

If a company had no net profits during the four-year initial period, and -- we're talking about a four-year, 1,461-day period -- would it have had any windfall tax liability?

A No. It couldn't --

Q No. Your answer is no. Is that correct?

A Yes.

Q Once a company's average annual profits during the initial period, multiplied by nine, the constant given in the statute, exceeded its flotation value such that it was liable for the windfall tax, is it not correct to state that the greater the profits, the greater its windfall tax liability would be?

A It is correct, once it exceeded.

Q It is correct. Thank you. If a company that was subject to the windfall tax had no net profits during the four-year initial period, but its stock price had tripled during that period because of the appreciation, for example, of land that it might have owned that, all of a sudden, was in an area that someone wanted to develop, would it have paid any windfall tax liability?

A There have been no profits for any of those four years.

Q I'll do it again because I really want the record to be perfectly clear, and I want to be sure you understand my question.

If a company that was subject to the windfall tax had no net profits during the four-year initial period -- just assume its expenses equaled its income -- but its stock price tripled because, during that period, land that it owned appreciated dramatically in value, and investors thought this would be a great play, and it caused the stock price to triple, would it have had any windfall tax liability?

A No, it wouldn't have.

Q It would not have. Let me put another hypothetical to you, a different set of facts. A company, subject to the windfall tax, had average

annual profits during its initial period, multiplied by nine, which were in excess of its flotation value --

A You mean the value for privatization purposes.

Q Yes, the value for privatization purposes, one of the two factors in the formula in the statute that the government has said is so clear. But its share price, its share price, fell during that time from flotation over a four-year period because of -- in this country, we have this problem -- maybe you're lucky enough in the U.K. not to have it, but let's assume asbestos lawsuits were brought against the company because it's an electric-generating company, and it used asbestos to insulate its piping, and, all of a sudden, every former employee got together in a class action, which maybe you don't even permit in the United Kingdom, and sued for astronomical sums.

A Actually, we do now. We do permit --

Q I feel sympathy for you, sir. You can tell where my sympathies lie on that issue, but --

A We have something called "group litigation orders," which have been used primarily in tax contexts, interestingly enough.

Q But let me be sure you're following me, sir. I'll restate it. I don't want the record to be

confused by our little byplay on procedure in the U.K.

My other hypothetical is that the company had annual average profits during its initial period, multiplied by nine, which were in excess of the privatization flotation value, but its share price fell during that time because of asbestos lawsuits pending against it. Would it have had a windfall tax liability?

A Yes, because the value, in profit-making terms, would have exceeded the value for privatization purposes.

Q So that even though its share price went down during that period, if its profits were large, large enough, there would be a tax imposed.

A Yes.

MR. GARDNER: I have no further questions.

Appendix C

EXCESS PROFITS TAXATION
by Kenneth James Curran

CHAPTER I
Fundamentals

An excess profits tax is a form of business income tax. It is distinguished from the ordinary business income tax in a fundamental way. Whereas the ordinary tax is levied on all of a firm's income, the excess profits tax is levied upon only a portion of the income. Under an excess profits tax the income is divided into two parts, one of which is exempt on the ground that it represents "normal" earnings while the other part is subject to the tax on the assumption that it is "different" or "excessive." [20]

To divide the income of a firm into "normal" and taxable portions requires a yardstick by which normal earnings may be measured; this yardstick is usually referred to as the "standard" of the tax. A number of standards have been employed in connection with excess profits taxes at one time or another. The commonest, and probably the most significant from the economist's point of view, are the "invested capital standard" and the "profits standard."

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[20] The exempt or normal part of a firm's income may, of course, amount to its entire income.

The invested capital standard operates on the assumption that the normal return to a business may be measured by the capital invested in that business, and this normal return (or exemption) is expressed as a per cent of the invested capital ordinarily measured as of the time when it was first made. The profits standard, on the other hand, measures normal profits by the average profits of a former so-called base period in which conditions are assumed to have been normal. It is difficult, if not impossible, for a tax employing this standard to avoid all reference to invested capital. Some firms may not have been in existence in the base period. Furthermore, base period earnings may not be a satisfactory criterion because the size of the firm may have changed since that time. Finally, the use of base earnings as the sole measure of normal profits may subject a firm, and even an entire industry, to destructive taxation if a state of depression existed in the base period. In such cases, it is customary to adjust the exemption, or provide a supplementary exemption, by reference to invested capital.

Other standards have been employed by excess profits taxes at various times. The Federal excess profits tax of 1933 based the exemption—that is, normal profits—on the value of the capital stock as declared by the taxpayer. Another recent excess profits tax, limited to certain military contracts of the national government, took as its measure both the contract price and the cost of performing the

contract.[21] An excess profits tax restricted to the liquor industry in Ohio likewise used costs as a measure of the exemption.[22] Although such standards may be successfully employed in special industries or for special purposes, they are logically inferior to the invested capital standard and the profits standard as means of isolating unusual profits in the taxation of business in general.

Unfortunately, confusion in terminology has surrounded the excess profits tax. Until recently, Congress tended to confine the term to a levy employing invested capital as a measure of normal earnings.[23] A typical wartime tax measuring normal earnings by the profits of a period before the war was distinguished as a "war profits tax." On the other hand, during World War I Cordell Hull, then a representative from Tennessee, maintained (with the British tax system in mind) that a genuine excess profits tax employed the profits standard.[24] The use of capital, he held, was merely a means of graduating the income tax. The customary practice today, and that followed by the author of the present study, is to use the term "excess profits tax" to describe any levy

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[21] The so-called Vinson-Trammell excess profits tax.

[22] *Tax Research Foundation, Tax Systems of the World* (Chicago: Commerce Clearing House, 1934), p. 55.

[23] For instance, the excess profits tax levied by the Revenue Act of 1918 was called the War Profits and Excess Profits Tax because it employed both the profits standard and the invested capital standard.

[24] *Congressional Record*, LVI, p. 10165.

that is confined to a segment of a taxpayer's income that is considered excessive, no matter by what standard of measurement it is determined.

The word "profits" as it appears in excess profits tax laws and throughout this study is synonymous with statutory net income. That is, it is the gross income of a firm less those costs that the law has permitted to be deducted. It is not used in the sense, frequently evident in economic theory, of a return to the owners of a business in their function as owners as distinct from their function as suppliers of capital.

The primary objective of an excess profits tax is to raise revenue for the government. There are, however, certain other objectives which may explain why this tax is employed. It has been recommended as a means of recapturing for the public the high profits of firms benefiting from special favors—such as tariff protection—received from the government. It has also been recommended as a supplement to price fixing in wartime because it enables the government to set prices at a sufficiently high level to assure the necessary production with the realization that a large portion of the extravagant profits that this policy yields to the low-cost firm will become part of the public coffers. It has been employed to control objectionable industries by discouraging profits obtained through aggressive exploitation of the market. It has been used, moreover, merely as a means of assisting the

collection of the capital stock tax in the United States. Although these objectives have played an important part in the formulation of excess profits taxes, they are logically and historically less significant than the two major objectives—namely, the taxation of business according to ability and the taxation of profits arising out of war.

The concept of "ability" as a guide in distributing the tax burden over the country has generally been used in a purely personal sense. Its measure has been vague but it has been related in a rough way to the personal sacrifices required by the taxpayer in the payment of taxes. It has been assumed that the wealthy individual has ample ability to bear taxation because he can turn over to the government a large portion of his income without sacrificing anything essential to comfort or health. On the other hand, it has been assumed that the poor individual has little ability to bear taxation since the payment of even the slightest portion of his income may deprive him of essentials. In this sense, of course, "ability" has no place in the taxation of business, for businesses are not living organisms and they can not make sacrifices of the sort described above. It is possible, however, to view the ability of a business in a different light. In a capitalistic economy, a man or a group of men embark upon a commercial undertaking for the sake of the profits they hope it will yield them. Were there no hope of profits the undertaking would be pointless and they would be unwilling to risk their capital, or even their

credit, in such an endeavor. It is quite probable, however, that in any particular case there is a minimum expected return sufficient to launch an undertaking or maintain it after it has been launched.[25] Profits exceeding this minimum return are superfluous in the sense that the hope of their gain was not necessary to attract the needed amount of capital or retain it in the business once it had been invested. Such superfluous or excessive profits have a peculiar ability to bear taxation, for even though they are confiscated by the government no repressive effect upon business is exerted in the sense that business is not deprived of the capital necessary for its existence.

The idea of an excess profits tax as a levy on business according to ability to pay leads to the employment of the invested capital standard rather than the profits standard. It is, of course, true that the profits standard has been recommended at times for this purpose. In a period of great economic disturbance, such as war, great changes in the earnings of business appear; against this chaotic state the earnings of a former period may well appear "normal." It may be assumed that the earnings of the former period emerged from the workings of competition and are therefore an indication of the return that business must have to

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[25] The rate necessary to attract a given amount of additional capital would be quite different from the rate necessary merely to maintain an investment once it has been made.

survive. However, it is clear that they indicate the necessary return only in a rough sense. The earnings of many firms in the so-called "normal" period may in no way have been related to those necessary to maintain the existing capital within the industry or to achieve a given growth. The earnings of a monopolistic firm, for example, are not ironed out by the forces of competition and may have been unnecessarily high. The earnings in highly competitive industries may also have been unnecessarily high if at the time the industries were in the process of adjustment. It is likewise obvious that the earnings in some monopolistic and in some competitive industries may well have been low (or even non-existent) in the "normal" period because of conditions prevailing then. As a result, the use of the profits standard will not lead to the taxation of business according to ability, for it will permit the extravagant earnings of some firms to escape and will subject the earnings of others to destructive taxation unless a special protective measure is taken. If the motive behind the excess profits tax is to tax business according to ability it will determine "normal" profits in relation to the capital invested in the business and will disregard the profits experience of any particular series of years.

The peculiar concept of ability to pay as used by the excess profits tax has both theoretical and practical limitations. From the theoretical side it must be recognized that in stressing one function of profits, another function is ignored; after all, profits

serve not only as a means of attracting capital to industry but also as an incentive to efficiency. It is the hope of increasing the income after the payment of all taxes that spurs management to greater efficiency. If all such additional income goes to the government, the effort necessary to secure greater efficiency is not likely to be made. The tendency of an excess profits tax to lead to wasteful expenditures and lax methods in industry has received a good deal of attention.

Although it is true that there is a minimum return that will be sufficient to attract a given amount of capital to a given industry, or to maintain the capital in the industry, it is impossible to draft a completely sound excess profits tax because of practical difficulties. There is not a single rate of return that is sufficient for all industries at all times. There are, rather, many rates of return. These rates will vary from time to time and from industry to industry. In an industry involving little risk the rate may be low, whereas in an industry involving great risk it may be high. Within a single industry the necessary rate of return may vary widely from time to time, depending upon the entire economic setting. It will be affected by the liberality of the tax law in defining invested capital and net income, by the probable distribution of a given income over time, by the weight and structure of the personal income tax, by the amount of new capital to be attracted to the industry, by the speed with which this capital is to be attracted, etc. Although all of these factors and many

others are pertinent in determining the necessary rate of return, it is obvious that they cannot all be considered by a legislature in the course of drafting an excess profits tax.

It is essential that the theoretical limitation and the complexity of the task of taxing business on the basis of ability to pay be understood if abuse of the excess profits tax is to be prevented. "Excess profits" can never be superfluous as an incentive to efficiency. The higher the tax rate, the greater the tendency toward slackness in industry. Furthermore, such a tax can not in practice isolate exactly that portion of the return not necessary to attract or maintain capital. If these limitations are understood and taken into consideration, an intelligently drawn excess profits tax may, under certain conditions, become an invaluable fiscal instrument.[26] Vast revenue may be raised by this tax with less disturbance to industry than would result from the effort to secure an equivalent amount by other means.

As has been pointed out, the second major objective of an excess profits tax is to tax profits arising out of war. When a country employing the tax is not directly involved in war this objective may be justified on the ground that war profits have a moral taint. When, on the other hand, a nation is actually

---

[26] The fiscal characteristics of the tax are discussed in Chapter IX.

engaged in warfare, the tax reflects popular aversion to the creation of vast fortunes out of the sacrifices necessitated by war demands.

If an excess profits tax is designed primarily to reach war gains, it will employ the profits standard. Normal earnings will be measured by the taxpayer's average profits in some period before the war, and the assumption will be made that an increase of his profits is attributable to the war. A prosperous firm will, of course, escape the burden of the tax if its profits have not become larger.

It is obvious that the excess profits tax likewise has its weakness as a means of reaching war profits. All changes in the profits of a firm between two periods of time can not be attributed to a single economic disturbance—even when it is one as important as war. The increase of a firm's earnings may in no way be attributable to the war. It is possible that its earnings would have been still higher had there been no war. On the other hand, a firm may be favorably affected by a war and yet earn less than before. The effect of war on profits could only be determined if it were possible to compare the wartime profits with the profits that would have been received had there been no war—which, of course, can not be done.

Nevertheless, the excess profits tax is the most satisfactory means we have of isolating war profits

for special taxation when the profits standard is employed.

AMICUS CURIAE BRIEF

No. 12-43

RECORDS AND BRIEFS

IN THE

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF PATRICK J. SMITH, ROBERT B. STACK, AND JOHN D. BATES AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*

Our interest in this case is an interest in the proper interpretation and application of the Internal Revenue Code.[1] Each of us has practiced exclusively in federal income tax law throughout our legal careers. One of us, Patrick J. Smith, has published a number of articles on issues of statutory interpretation and administrative law in the context of federal income taxation. Two of us, Robert B. Stack and John D. Bates, practice primarily in the federal income taxation of international activities. We believe this brief will bring to the Court's attention relevant matter not likely to be brought to the Court's attention by the parties and thus serves the purpose identified for *amicus curiae* briefs in Rule 37.

SUMMARY OF ARGUMENT

Respondent's regulations provide that in order to be creditable against United States income tax, a foreign tax must satisfy three requirements: a realization requirement, a gross receipts requirement, and a net income requirement. 26 C.F.R. § 1.901-2(b)(1). Throughout this case, respondent has contended the creditability of the United Kingdom windfall tax must be determined by applying these requirements to the formula for the

[1] No party or counsel for a party authored this brief in whole or in part. No party, counsel for a party, or person other than *amici curiae* made a monetary contribution intended to fund the preparation or submission of the brief. Both parties have consented to the filing of this brief.

windfall tax in the U.K. statute, rather than by applying them to petitioner's algebraically equivalent reformulation. We agree with petitioner that it is appropriate to apply these requirements to petitioner's algebraically equivalent reformulation in determining whether the windfall tax is creditable. We also agree with petitioner that, when these requirements are so applied, they are satisfied, and the tax is a creditable excess profits tax.

However, we submit that even if, as respondent contends, the creditability of the windfall tax is determined by applying these requirements to the U.K. statutory formula for the tax, the requirements are satisfied, and consequently the windfall tax is a creditable income tax. The conclusion the requirements are satisfied when applied to the U.K. statutory formula for the tax follows directly from positions respondent has taken in this case.

In the Tax Court, respondent contended the windfall tax is not an excess profits tax, as petitioner contends, but that the tax instead recaptures a tax on unrealized appreciation that would have applied to the companies subject to the windfall tax at the time of each company's flotation if the companies had not been statutorily exempted from this unrealized appreciation tax. Respondent repeatedly described the effect of the windfall tax as being "to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization." Opening Brief for Respondent at 21, 105, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07). Respondent contended the windfall tax failed the realization requirement because the regulations provide that a tax on unrealized

appreciation can satisfy this requirement only if the foreign tax jurisdiction does not impose a second tax on the same appreciation when the appreciation is realized, and the windfall tax fails this no-second-tax test. *See* 26 C.F.R. § 1.901-2(b)(2)(i)(C). Respondent repeated these arguments in the Third Circuit.

In making these arguments, respondent apparently overlooked another rule regarding the realization requirement. This rule provides that the realization requirement is satisfied if a tax imposed prior to realization represents "the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer." 26 C.F.R. § 1.901-2(b)(2)(i)(B). In contrast to the unrealized appreciation rule, this rule regarding the recapture of a prior tax allowance does not require that the foreign tax jurisdiction must not later impose a second tax on the same amount. Under respondent's characterization of the windfall tax as the recapture of a tax from which the companies were previously exempted, the windfall tax satisfies the realization requirement because the tax comes within the rule that the recapture of a prior tax allowance satisfies the realization requirement regardless of whether the same amount is later taxed a second time.

In addition to satisfying the realization requirement, the windfall tax also satisfies the gross receipts requirement when this requirement is applied to the U.K. statutory formula for the tax, because a tax based on the fair market value of assets satisfies the gross receipts requirement. *See* 26 C.F.R. § 1.901-2(b)(3)(i)(B). Respondent has argued throughout this case that the U.K. statutory

formula for the windfall tax was based on the value of the companies subject to the tax because the tax base was calculated by multiplying each company's actual profits by a price-earnings ratio. Respondent has consistently contended this formula is a generally accepted method of determining a company's value. Based on respondent's position that the windfall tax was based on fair market value, and the rule that a tax based on fair market value satisfies the gross receipts requirement, the windfall tax satisfies this requirement.

The windfall tax also satisfies the net income requirement when this requirement is applied to the U.K. statutory formula for the tax, because the value of each company subject to the tax was determined under the U.K. statutory formula by multiplying the company's actual profits by a price-earnings ratio. The costs incurred in earning those profits were necessarily recognized in calculating the profits used in this formula. In addition, a tax on the unrealized appreciation in the value of a business necessarily reflects the costs that were incurred by that business, and that affected that appreciation, during the period in which the appreciation occurred. Moreover, any tax on unrealized appreciation satisfies the net income requirement by subtracting an initial value from appreciated value in calculating the tax base.

Thus, when the three requirements for creditability in respondent's regulations are applied to the U.K. statutory formula for the windfall tax, the tax satisfies each requirement, based on positions respondent has taken in this case. Consequently, the windfall tax is creditable.

Finally, while petitioner has not challenged the validity of any aspect of the regulations, nevertheless, both the realization requirement and the gross receipts requirement, in the attenuated form these requirements take in respondent's regulations, are vulnerable to challenge under the arbitrary and capricious standard of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), because of respondent's failure to explain, at the time these regulations were issued, the reasons for imposing these requirements in such an attenuated form.

STATEMENT

Because the regulations are central to the resolution of this case, an understanding of their content and history is essential to that resolution. The Internal Revenue Code allows a credit against U.S. income tax for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. § 901(b)(1). However, the Internal Revenue Code provides no guidance for determining which foreign taxes qualify as "income, war profits, and excess profits taxes" for purposes of this credit.

In 1983, respondent issued regulations for determining which foreign taxes are creditable. T.D. 7918, *Creditability of Foreign Taxes*, 48 Fed. Reg. 46272 (October 12, 1983). The regulations provide that, to be creditable, a tax must satisfy this test: "The predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. § 1.901-2(a)(1)(ii). To determine a tax's predominant

character, the regulations provide: "The predominant character of a foreign tax is that of an income tax in the U.S. sense ... [i]f, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. § 1.901-2(a)(3)(i) (alteration added).

Regarding this "net gain" requirement, the regulations provide:

> A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

26 C.F.R. § 1.901-2(b)(1). Thus, to be creditable under the regulations, a tax must satisfy three requirements: a realization requirement, a gross receipts requirement, and a net income requirement.

The realization requirement provisions are lengthy and complex, but central to resolving this case. These provisions begin as follows:

> A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—
>
> (A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code.

26 C.F.R. § 1.901-2(b)(2)(i). However, the realization requirement is also satisfied in two additional

situations where a tax is not imposed "[u]pon or subsequent to ... 'realization events.'"

First, a tax satisfies the realization requirement if the tax is imposed "[u]pon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer." 26 C.F.R. § 1.901-2(b)(2)(i)(B). Second, a tax satisfies the realization requirement if the tax is imposed on certain additional prerealization events other than the recapture of a prior tax allowance. 26 C.F.R. § 1.901-2(b)(2)(i)(C) ("Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section").

Two types of tax come within this second category of taxes on prerealization events other than the recapture of a prior tax allowance: (1) a tax "based on the difference in the values of property at the beginning and end of a period," 26 C.F.R. § 1.901-2(b)(2)(i)(C)*(1)*, and (2) a tax imposed on "the physical transfer, processing, or export of readily marketable property," 26 C.F.R. § 1.901-2(b)(2)(i)(C)*(2)*. However, a tax imposed on this second category of prerealization events other than the recapture of a prior tax allowance satisfies the realization requirement "only if the foreign country does not, upon the occurrence of a later event ..., impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event." 26 C.F.R. § 1.901-2(b)(2)(i)(C).

The regulations also provide that a tax satisfies the realization requirement even though the tax is

imposed in situations that do not meet the requirements described above, provided those situations are not the predominant situations to which the tax applies:

> For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code.

26 C.F.R. § 1.901-2(b)(2)(i).

The gross receipts requirement provisions begin as follows:

> A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—
>
> (A) Gross receipts; or
>
> (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

26 C.F.R. § 1.901-2(b)(3)(i). The gross receipts requirement provisions are considerably less detailed than the realization requirement provisions.

The net income requirement provisions begin as follows:

> A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts

> (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit—
>
> (A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or
>
> (B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

26 C.F.R. § 1.901-2(b)(4)(i). While the net income requirement provisions contain considerable additional detail, this detail is not relevant in this case.

The preamble to the regulations explained that the test for creditability adopted in the regulations was the test applied in three judicial decisions:

> Under these final regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies. This standard, found in § 1.901-2(a)(3)(i), adopts the criterion for creditability set forth in *Inland Steel Company v. U.S.*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America National Trust and Savings Association v. U.S.*, 459 F.2d 513 (Ct. Cl. 1972), and *Bank of America National Trust and Savings Association v. Commissioner*, 61 T.C. 752 (1974). The regulations set forth three tests for determining if a foreign tax is likely to reach

> net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

48 Fed. Reg. at 46273. This was the only explanation the preamble provided for adopting the three-part test based on realization, gross receipts, and net income. However, none of the three judicial decisions cited in the preamble applied a three-part test to determine the creditability of a foreign tax.

The 1983 regulations followed a series of proposed and temporary regulations, which provide relevant context for understanding and evaluating the final regulations. Respondent published proposed regulations in 1979. LR-100-78, *Creditability of Foreign Taxes*, 44 Fed. Reg. 36071 (June 20, 1979). These 1979 proposed regulations listed three requirements for creditability. However, these requirements were not identical to the three requirements in the final regulations. Like the final regulations, these proposed regulations included a realization requirement and a net income requirement. In contrast to the final regulations, instead of a gross receipts requirement, these proposed regulations required that the tax must be based on income: "Paragraph (b)(1) requires that the base on which the tax is computed must be income. The tax must not be based on wealth, accumulated profits, or other non-income amounts." 44 Fed. Reg. at 36073. The preamble to these proposed regulations provided no explanation for imposing these three requirements.

In addition to this difference between the 1979 proposed regulations and the final regulations regarding the identity of one of the requirements for creditability, these proposed regulations also differed substantially from the final regulations in the content of the realization requirement. The realization requirement provisions in these proposed regulations were significantly less detailed than the provisions in the final regulations. These proposed regulations included a rule like the rule in the final regulations that the realization requirement was satisfied by a tax imposed upon or subsequent to an event that would be considered a realization event for U.S. income tax purposes. However, in contrast to the final regulations, these proposed regulations did not contain detailed rules regarding prerealization events.

Instead, the only other situation identified in the 1979 proposed regulations in which a tax that was not imposed on, or subsequent to, a realization event satisfied the realization requirement was where the tax was imposed in the following situation:

> [T]he export from the foreign country of stock in trade or other property of a kind which properly would be included in the inventory of the taxpayer if on hand at the close of the taxable year, or of property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business, provided that the tax is computed on the basis of the fair market value of such property of the taxpayer at the time of the export.

44 Fed. Reg. at 36073. This provision was applicable only if the foreign jurisdiction imposed no charge on the disposition of the same property outside the foreign jurisdiction in a realization event. *Id.* The preamble to the 1979 proposed regulations provided no explanation of the reasons this type of tax satisfied the realization requirement. Because these proposed regulations identified fewer situations in which the realization requirement was satisfied than the final regulations, the realization requirement in these proposed regulations was considerably more restrictive than in the final regulations.

The 1979 proposed regulations were followed by temporary regulations in 1980. T.D. 7739, *Temporary Income Tax Regulations Relating to Creditability of Foreign Taxes*, 45 Fed. Reg. 75647 (March 17, 1980). These 1980 temporary regulations brought the three-part test from the 1979 proposed regulations closer to the three-part test in the final regulations by substituting a gross receipts requirement for the income requirement in the 1979 proposed regulations. The preamble to the temporary regulations provided no explanation for substituting a gross receipts requirement for the income requirement.

The realization requirement provisions in the 1980 temporary regulations were substantially the same as those in the 1979 proposed regulations except that the provision in the 1979 proposed regulations regarding the export from the foreign country of stock in trade or similar property was modified in the 1980 temporary regulations to apply to "the transfer or processing of readily marketable property." 45 Fed. Reg. at 75649. This rule was

subject to the requirement that the foreign jurisdiction not impose a charge on the same amount on the later occurrence of another event. *Id.* The preamble to these temporary regulations provided no explanation for this change.

The gross receipts requirement provisions in the 1980 temporary regulations were more complex than the corresponding provisions in the final regulations:

> (3) *Gross receipts.* A foreign charge meets the gross receipts requirement if it is imposed, without substantial deviation, on the basis of—
>
> (i) Gross receipts; or
>
> (ii) Gross receipts computed under a method that is designed to produce an amount that is not greater than fair market value and that, in fact, produces an amount that approximates, or is less than, fair market value, but only in the case of—
>
> (A) Transactions with respect to which it is reasonable to believe that gross receipts may not otherwise be clearly reflected; or
>
> (B) Situations to which paragraph (c)(2)(i)(C) of this section (relating to a transfer or processing of readily marketable property) applies.

45 Fed. Reg. at 75649. Thus, under these temporary regulations, the gross receipts requirement was satisfied by a tax based on fair market value, provided the realization requirement was satisfied because the tax was imposed on the transfer or processing of readily marketable property. The preamble to these temporary regulations provided no explanation for adopting this rule that a tax based on

fair market value satisfied the gross receipts requirement.

The last step before the final regulations was proposed regulations that were issued in April of 1983. LR-100-78, *Foreign Tax Credit*, 48 Fed. Reg. 14641 (April 5, 1983). The 1983 proposed regulations brought the realization requirement considerably closer to the requirement in the final regulations. These proposed regulations expanded the categories of events other than realization events that satisfied the realization requirement by adding a category for unrealized appreciation in the value of certain types of property. Under these proposed regulations, the categories of prerealization events satisfying the realization requirement were as follows:

> (1) The imposition of the tax upon such prerealization event is based on the difference in the values of stock, securities or readily marketable property ... at the beginning and end of a taxable period; or
>
> (2) The prerealization event is the physical transfer, processing, or export of readily marketable property.

48 Fed. Reg. at 14644. The category for unrealized appreciation was narrower than in the final regulations because the rule in these proposed regulations was limited to stock, securities, and readily marketable property, while the provision in the final regulations applies to unrealized appreciation in any type of property. This prerealization event rule was subject to the requirement that the foreign jurisdiction not impose another tax on the same amount on the occurrence of a later event. The preamble to these proposed

regulations provided no explanation for expanding the categories of prerealization events satisfying the gross receipts requirement. These proposed regulations did not include any provision like the rule in the final regulations regarding the recapture of a prior tax allowance.

The 1983 proposed regulations also included provisions regarding imputed rental income on a personal residence and stock dividends like the provisions in the final regulations. The preamble to these proposed regulations provided no explanation for the adoption of this rule relating to imputed rental income and stock dividends.

The gross receipts requirement provisions in the 1983 proposed regulations were similar to those in the 1980 temporary regulations. As in the 1980 proposed regulations, the provision regarding gross receipts determined by reference to fair market value applied to two situations, which paralleled the two situations in the 1980 proposed regulations, except that the second situation was expanded to cover all prerealization events that satisfied the realization requirement, corresponding to the expansion of the situations in which the realization requirement was satisfied to include certain taxes on unrealized appreciation.

ARGUMENT

I. Realization requirement

A. When the realization requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because respondent has conceded the windfall tax recaptures a prior U.K. tax allowance.

When the realization requirement is applied to the U.K. statutory formula for the windfall tax, this requirement is satisfied because respondent has conceded the tax recaptured a prior U.K. tax allowance. Respondent's opening brief in the Tax Court argued at considerable length that the windfall tax was not a tax on excess profits, as petitioner contends, but that the tax instead recaptured a tax on the unrealized appreciation of the company's assets that would have applied to the company's flotation if the companies subject to the windfall tax had not been statutorily exempted from this tax on unrealized appreciation. Respondent repeated this argument in the Third Circuit. Respondent's characterization of the windfall tax is a binding concession by respondent. Based on respondent's position that the windfall tax recaptured a prior tax exemption, the windfall tax satisfies the realization requirement because the tax comes within the rule in the regulations that a recapture of a prior tax allowance satisfies the realization requirement.

Respondent's opening brief in the Tax Court included the following discussion of the "basis of the proposal" that was subsequently enacted as the windfall tax:

> .... [T]he Andersen team's November 1996 PowerPoint presentation and the testimony of Dr. Wales reveal that the underlying design of the Windfall Tax was not to tax excess profits. Rather, *the basis of the proposal was to reinstate the Taxation of Chargeable Gains Act (TCGA) taxing mechanism that would have taxed the U.K. Windfall Tax Companies' unrealized appreciation at the time of flotation had the companies not been specifically exempted from the legislation.*
>
> The Andersen team's Windfall Tax proposal, as presented in its November 1996 PowerPoint presentation, references the TCGA. During his testimony, Dr. Wales described the portion of the Andersen team's presentation relating to the TCGA as "the guts of the presentation." The TCGA imposed a tax on capital gains earned by individuals and corporations. As it relates to the Andersen team's Windfall Tax proposal, the operative sections of the TCGA are sections 171 and 179. TCGA section 171 allows a corporation to transfer appreciated assets to a subsidiary in which it owns 75% or more of the shares without triggering a tax on the gain inherent in the asset. If a corporation disposes of its stock in a subsidiary to which TCGA section 171

applied within six years of that transfer of appreciated assets, then TCGA section 179 taxes the subsidiary on the gain that avoided capital gains taxation on the initial transfer.

When the Windfall Tax Companies were privatized, appreciated assets were transferred from public corporations to new companies, in which the public corporations held shares, triggering TCGA section 171. Shortly thereafter, the stock of the new companies was floated, triggering TCGA section 179. When the Windfall Tax Companies were privatized, TCGA section 179 would have applied to trigger U.K. corporation tax on the Windfall Tax Companies on the unrealized appreciation in the assets transferred from the public corporations, had Parliament not exempted them from the application of this provision. Through specific legislation enacted by Parliament in connection with the privatization process, certain Windfall Tax Companies were exempted from TCGA section 179. *The Andersen team's proposal to tax the difference between the value of the Windfall Tax Company at the time of privatization and the price at which the Windfall Tax Company was actually offered at privatization effectively reinstated TCGA section 179 to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization.* To the extent the underlying design of the Windfall Tax and its purported

"substance" are deemed relevant in applying the regulatory net gain tests, the record confirms that the "substance" of the tax base was not excess profits, but rather was the unrealized appreciation in the Windfall Tax Companies' assets. The exemption from corporate-level tax on this unrealized gain that would otherwise have been triggered on flotation, a benefit conferred by the implementing legislation, constituted the "windfall" from which the privatized companies were benefiting at the time of flotation.

In essence, the Andersen team proposed to reinstate a tax on appreciated but unrealized gain that would have applied to the Windfall Tax Companies upon the flotation of their shares at the time of their privatization. This tax base, revealed by the team's PowerPoint proposal and Dr. Wales' testimony to be the underlying design of the proposal ultimately enacted as the U.K. Windfall Tax, would fail the realization test, because the gain inherent in the Windfall Tax Companies' appreciated assets was unrealized. Although not relied on by petitioner, if structured as a tax on unrealized appreciation the U.K. Windfall Tax would also fail the alternative realization test set forth in Treas. Reg. § 1.901-2(b)(2)(i)(C), which allows mark-to-market regimes to meet the realization requirement, because there was no provision under U.K. law to exempt the unrealized

> gain in the Windfall Tax Companies' assets from a second tax upon a subsequent sale of the assets.

Opening Brief for Respondent at 103-106, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07) (emphasis added; citations omitted).

Elsewhere in this same brief, respondent summarized these points as follows:

> Ultimately, the Andersen team proposed to tax the difference between the value of the Windfall Tax Company at the time of privatization and the price at which the Windfall Tax Company was actually offered at privatization, in essence, *reinstating TCGA section 179 to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization.*
>
> The Windfall Tax that was enacted by Parliament had the same fundamental structure as the Andersen team's Windfall Tax proposal.

Id. at 21 (emphasis added; citations and paragraph numbers omitted).

Respondent reiterated these points in his opening brief in the Third Circuit:

> .... [U]nder U.K. law, the privatization was a tax-free event for the windfall companies. Although the companies ordinarily would have been subject to a U.K. tax on their unrealized built-in gains upon privatization (and would have received a stepped-up basis for purposes of determining future taxable gain or loss), Parliament

> exempted the companies from that particular tax when it privatized them.
>
> *Evidence in the record suggests that the windfall tax may have been intended to recapture the tax revenue lost as a result of this exemption....* [B]ecause the companies received no basis step-up as a result of paying the windfall tax—and so would be subject to a second corporation tax on the disposition of the appreciated assets—a tax on unrealized built-in gain would fail the realization test. See Treas. Reg. § 1.901-2(b)(2)(i)(C) (providing that a tax on a prerealization event satisfies the realization test only if the foreign country does not impose a second tax on the same income upon the occurrence of a later event).

Opening Brief for the Appellant at 29 n.4, *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069) (emphasis added; citations omitted).

Thus, respondent contended repeatedly and at considerable length in the Tax Court and the Third Circuit that the effect of the windfall tax was "to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization." However, as noted in the passages quoted above from respondent's briefs, the regulations provide that a tax on the category of prerealization events that includes unrealized appreciation satisfies the realization requirement only if the following condition is satisfied:

> [O]nly if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the

> income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event).

26 C.F.R. § 1.901-2(b)(2)(i)(C). As respondent noted in the passages quoted above, this condition is not satisfied by the windfall tax because there is no mechanism in the U.K. statute exempting this unrealized appreciation from being taxed a second time when the appreciation is realized.

However, respondent's briefs neglected to mention the rule concerning the recapture of prior tax allowances. The regulations provide that a tax imposed in the following circumstances satisfies the realization requirement: "Upon the occurrence of an event prior to a realization event (a 'prerealization event') provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer." 26 C.F.R. § 1.901-2(b)(2)(i)(B). Respondent argued in the Tax Court and the Third Circuit that the windfall tax represents a recapture of the tax on unrealized appreciation that would have applied at the time of each company's flotation if these companies had not been statutorily exempted from this tax. Exemption from an otherwise applicable tax is clearly a "tax allowance." Thus, respondent contended the windfall tax represented the recapture of a tax allowance previously accorded to the taxpayer.

The position respondent expressed in its briefs in the Tax Court and the Third Circuit regarding the nature of the windfall tax is a binding concession by respondent. "A court can appropriately treat statements in briefs as binding judicial admissions of fact." *Purgess v. Sharrock*, 33 F.3d 134, 144 (2d Cir. 1994). Issues of foreign law traditionally have been treated as issues of fact rather than issues of law. *See, e.g.*, Roger M. Michalski, *Pleading and Proving Foreign Law in the Age of Plausibility Pleading*, 59 Buffalo Law Review 1207, 1208 n.7 (2011). While Federal Rule of Civil Procedure 44.1 changes that approach in limited respects ("The court's determination [of foreign law] must be treated as a ruling on a question of law"), this limited alteration does not mean the traditional approach is altered in other respects. The Advisory Committee Notes explain this change: "[T]he court's determination of an issue of foreign law is to be treated as a ruling on a question of 'law,' not 'fact,' so that appellate review will not be narrowly confined by the 'clearly erroneous' standard of Rule 52(a)." On any point not directly addressed in Rule 44.1, the prior rule that issues of foreign law are issues of fact should remain the controlling principle. An admission by a party is not a determination by the court and is therefore not covered by Rule 44.1. Tax Court Rule 146 is identical to Rule 44.1.

Consequently, based on respondent's position that the windfall tax recaptured a prior tax allowance, the recapture rule in section 1.901-2(b)(2)(i)(B) is applicable to the windfall tax. The recapture rule in section 1.901-2(b)(2)(i)(B) contains no provision like the one applicable to the unrealized

appreciation rule in section 1.901-2(b)(2)(i)(C) that conditions applicability of the rule on the foreign jurisdiction not taxing the unrealized appreciation a second time when the appreciation is realized. Moreover, it cannot be contended the unrealized appreciation rule in section 1.901-2(b)(2)(i)(C) overrides the recapture rule in section 1.901-2(b)(2)(i)(B), because the unrealized appreciation rule is explicitly made applicable only to a prerealization event "other than one described in paragraph (b)(2)(i)(B) of this section." Thus, the regulations are explicit that the recapture rule takes priority over the unrealized appreciation rule in cases where both rules might otherwise potentially apply.

As a result, when the realization requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because, under the regulations, a tax on the recapture of a prior tax allowance satisfies the realization requirement regardless of whether the same item is subject to a second tax at a later time, and because respondent contended in both the Tax Court and the Third Circuit that the windfall tax recaptured a tax on unrealized appreciation that would have applied to the companies subject to the windfall tax if the companies had not been exempted from that tax.[2]

[2] In the Tax Court, petitioner disputed that the tax from which the companies were exempted at the time of flotation was a tax on unrealized appreciation. Petitioner contended that the transfer of assets to a subsidiary is a realization event even if no tax is imposed on that transfer. *See* Reply Brief for Petitioner at 101-03, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07). In the Third Circuit, respondent argued that the prior tax was triggered by the sale of the subsidiary's stock rather than the asset transfer and that this was not a realization event for the subsidiary. Opening Brief for the Appellant at 29 n.4, *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069). However,

B. The realization requirement, in the attenuated form this requirement takes in the regulations, is vulnerable to challenge under the APA's arbitrary and capricious standard.

Petitioner has not challenged the validity of any aspect of respondent's regulations. As a result, the Court is unlikely to decide this case on the basis that the regulations are invalid. Nevertheless, it is relevant as background and context that several aspects of these regulations are vulnerable to challenge under the arbitrary and capricious standard of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A). The imposition of some form of realization requirement for creditability is supported by the role played by realization in U.S. income tax law. However, because the attenuated form taken by the realization requirement in the regulations is so far removed from the conventional understanding of realization, it is not clear what purpose is served by

the issue of whether this prior tax was a tax on realized or unrealized appreciation does not affect respondent's characterization of the windfall tax as a recapture of the prior tax exemption. Petitioner also disputed this characterization of the windfall tax. *See* Reply Brief for Petitioner at 103-06, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07). The Tax Court agreed with petitioner that the prior tax from which the companies were exempted was a tax on a realization event but treated petitioner's argument that respondent's characterization of the windfall tax was incorrect as a concession by petitioner that made it unnecessary to decide the case on that basis. *See* 135 T.C. at 333 n.25. Because petitioner argued in the alternative that the prior tax would have satisfied the realization requirement, treating petitioner's argument against respondent's characterization as a concession seems questionable. Moreover, if this was a concession, respondent did not accept it, because respondent repeated the argument in the Third Circuit.

retaining a realization requirement in this attenuated form.

The two most commonly identified items of economic income that do not satisfy a conventional understanding of realization are the unrealized appreciation in the value of property that is held by a taxpayer, but that has not been sold, and imputed rental income on a taxpayer's personal-use property, such as a personal residence. *See, e.g., Cottage Savings Association v. Commissioner*, 499 U.S. 554, 559 (1991) ("Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer 'realizes' the gain or loss"); *Helvering v. Independent Life Insurance Co.*, 292 U.S. 371, 379 (1934) ("The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment"); Joseph Isenbergh, *The End of Income Taxation*, 45 Tax L. Rev. 283, 288 (1989) ("The exclusion from taxable income of virtually all imputed ... income ... drives taxable income apart from economic income. Imputed income is the value derived from the ownership of durable assets").

However, under the regulations, taxes that reach either or both of these types of economic income satisfy the realization requirement. Under the regulations, a tax on unrealized appreciation satisfies the realization requirement, provided the same appreciation is not taxed a second time when the appreciation is realized. 26 C.F.R. § 1.901-2(b)(2)(i)(C). In addition, under the regulations, a tax that includes in its tax base imputed rental

income on a personal residence satisfies the realization requirement, provided such imputed rental income is not the predominant item in the tax base. 26 C.F.R. § 1.901-2(b)(2)(i).

In light of these significant departures from the conventional understanding of realization, there is a serious question regarding what purpose is served by retaining a realization requirement in such an attenuated form. Commentators have noted this anomaly regarding the realization requirement in the regulations. *See, e.g.*, D. Kevin Dolan, *General Standards of Creditability Under §§ 901 and 903 Final Regulations – New Words, Old Concepts*, 13 Tax Management International Journal 167, 169, 170 (1984) ("The [provisions of the] regulations [on realization] contain exceptions ... which almost engulf the general rule"; "The liberalization of the realization requirement seems to have been made on the basis realization is not a fundamental characteristic of the U.S. tax system.... [O]ne wonders why the [realization] requirement was not simply eliminated") (alterations added); Marc M. Levey, *Creditability of a Foreign Tax: The Principles, the Regulations, and the Complexity*, 3 Journal of Law and Commerce 193, 209-10 (1983) ("[I]t is difficult to visualize a tax failing the overall issue ... because of a realization taint. This result appears to be intentional.... [T]he denial of a credit due to a realization flaw tended to lead to international double taxation, thus frustrating the purpose of the foreign tax credit system") (alterations added).

None of the preambles to the various proposed, temporary, or final regulations explained the rationale for retaining a realization requirement in

the highly attenuated form that requirement takes in the regulations. Respondent's failure to provide such an explanation provides a basis for challenging the imposition of the realization requirement in the regulations under the APA's arbitrary and capricious standard. *See, e.g.*, *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43, 48-49 (1983); *Judulang v. Holder*, 131 S. Ct. 476, 479 (2011). Because petitioner has not challenged the validity of the regulations, the Court's opinion should make clear that the Court is not expressing a view on the validity of the realization requirement or any other aspect of the regulations.

However, even though the realization requirement in the regulations is vulnerable to challenge under the arbitrary and capricious standard, it is nevertheless clear that, when this requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement, based on respondent's concession that the tax recaptures the tax on unrealized appreciation from which the companies subject to the windfall tax were statutorily exempted at the time of their flotation.

II. Gross receipts requirement

A. When the gross receipts requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because respondent has conceded the tax is based on fair market value.

In addition to satisfying the realization requirement, the windfall tax also satisfies the gross receipts requirement when this requirement is applied to the U.K. statutory formula for the tax. Under the regulations, the gross receipts requirement is satisfied if the foreign tax is imposed on an amount that is "computed under a method that is likely to produce an amount that is not greater than fair market value." 26 C.F.R. § 1.901-2(b)(3)(i)(B). The windfall tax satisfies the gross receipts requirement because respondent has conceded the tax was based on the fair market value of each company that was subject to the tax.

In light of the rules providing that taxes on unrealized appreciation can satisfy the realization requirement, it is understandable why the regulations provide that a tax that is based on fair market value satisfies the gross receipts requirement. A tax on unrealized appreciation is necessarily based on the fair market value of the appreciated property. It would be nonsensical for the regulations to contain provisions permitting a tax on unrealized appreciation to satisfy the realization requirement if such taxes would inevitably fail the gross receipts requirement.

Respondent argued at length in both the Tax Court and the Third Circuit that the statutory formula in the windfall tax for determining the profit-making value of a company is a reasonable method for determining the company's fair market value. Respondent's opening brief in the Tax Court included the following discussion of this point:

> The U.K. Windfall Tax is a tax on the difference between two values. The first value, Profit-Making Value, is calculated by multiplying an earnings multiple of nine by a company's average annual book earnings. *The earnings multiple of nine was a reasonable multiplier to use to approximate a fair market value for SWEB at the time of flotation.* As respondent's expert witness Peter Ashton opined, *the method used to calculate the Profit-Making Value represents a generally accepted methodology for computing the equity value of a company.*

Opening Brief for Respondent at 107, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07) (emphasis added; citations omitted).

Respondent's opening brief in the Third Circuit included the following discussion of the same subject:

> [T]he statute provided that profit-making value was to be determined by multiplying the [*sic*] "the applicable price-to-earnings ratio" of 9 by "average annual profit." As the Commissioner's accounting expert, Peter Ashton, explained, *this formulation is widely used in determining company value.* He stated that the statutory formula for profit-making value is "identical to the market

> multiples method for computing the value of a firm, or more precisely the equity (stock) value of the firm," and that "[m]ultiples such as the P/E [price-to-earnings] ratio are frequently used in valuation analyses and are viewed as an accurate means to determine value," citing to numerous valuation treatises and articles in support. Even taxpayer's expert, Stewart Myers, acknowledged that *multiplying earnings by a price-to-earnings ratio is a recognized method for estimating the economic value of a company. And U.S. case law is replete with instances in which a company's value was determined by computing a multiple of net earnings, where the multiple was a price-to-earnings ratio.* Inland Revenue's bulletin summarizing the windfall tax confirms that the statutory formula for profit-making value was intended to yield company value: "Company value will be calculated by multiplying average annual profits after tax over the period by a price/earnings ratio of 9."

Opening Brief for the Appellant at 25-27, *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069) (emphasis added; citations omitted). Respondent repeated these arguments in his response to petitioner's petition for certiorari:

> Calculating property value based on the property's ability to generate income is a widely used valuation method called the "income capitalization method. In the United States, various property taxes permit

> or require taxable value to be determined based on the ability of property to generate income.

Brief for the Respondent at 10 (citations omitted).

Thus, when the gross receipts requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because the regulations provide that a tax based on fair market value satisfies the gross receipts requirement, and because respondent has contended throughout the litigation of this case that the U.K. statutory formula for determining profit-making value is a reasonable method of determining fair market value.

The temporary and proposed regulations that were issued prior to the final regulations contained provisions explicitly stating the gross receipts requirement was satisfied by a tax on unrealized appreciation provided the tax satisfied the realization requirement. The preamble to the final regulations explained that the elimination from the final regulations of these explicit provisions coordinating the gross receipts requirement with the realization requirement represented *a relaxation of restrictions* on the rule that a tax based on fair market value satisfies the gross receipts requirement:

> The regulations also allow a tax imposed on a base of estimated gross receipts if the method used is likely to produce an amount that is not greater than fair market value. *The proposed regulations would have allowed a tax imposed on estimated gross receipts only in the case of*: (1) Transactions with respect to which it is reasonable to believe

> that gross receipts may not otherwise be clearly reflected, or (2) *certain prerealization events*. In response to comments made by the public, *these restrictions have been deleted*.

48 Fed. Reg. at 46273 (emphasis added).

In light of this explanation that this change in the final regulations was intended to eliminate restrictions on the applicability of the rule that a tax on fair market value satisfies the gross receipts requirement, the implication of this explanation is that any tax based on fair market value should satisfy the gross receipts requirement. As an interpretation of regulations by the agency that issued them, this explanation of the fair market value rule under the gross receipts requirement in the preamble to the final regulations is entitled to deference under the principle applied in cases such as *Auer v. Robbins*, 519 U.S. 452 (1997). An agency's interpretation of its own regulations that is presented in the preamble to those regulations does not raise any of the concerns relating to according deference to an agency's interpretation of its own regulations that have been identified in the case of interpretations that are expressed by an agency at a time *later than* the issuance of the regulations to which the interpretation relates. *See, e.g., Christopher v. SmithKline Beecham Corp.*, 132 S. Ct. 2156, 2168 (2012); *Talk America, Inc. v. Michigan Bell Telephone Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring). The government made this same point regarding the application of the *Auer* principle to preambles to regulations in its briefing in a tax case decided by the Court last term:

> Deference to the Department's interpretation of the applicability clause is particularly appropriate because the Department issued that explanation contemporaneously with the rule itself, in the *Federal Register* preamble. Deferring to such a contemporaneous agency clarification cannot "encourage[ ] the agency to enact vague rules which give it the power, in future adjudications, to do what it pleases." *Talk Am., Inc. v. Michigan Bell Tel. Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring); cf. John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 Colum. L. Rev. 612, 689-690 (1996).

Reply Brief for the United States at 18-19, *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012) (No. 11-139). *See also* Kevin M. Stack, *Interpreting Regulations*, 111 Michigan Law Review 355 (2012) (arguing that regulations should be interpreted by reference to their preambles).

Since respondent has conceded that the windfall tax was based on fair market value, the windfall tax satisfies the gross receipts requirement because of the rule that a tax based on fair market value satisfies the gross receipts requirement.

B. The gross receipts requirement, in the attenuated form this requirement takes in the regulations, is vulnerable to challenge under the APA's arbitrary and capricious standard.

As noted above, while petitioner has not challenged the validity of any aspect of the regulations, nevertheless, several aspects of the regulations are vulnerable to such a challenge. As discussed above, the imposition of a realization requirement in the attenuated form this requirement takes in the regulations is one aspect of the regulations that is vulnerable to challenge. Another aspect of the regulations that is vulnerable to challenge is the gross receipts requirement, particularly in light of the attenuated form taken by the realization requirement in the regulations.

It is clear that a gross receipts requirement bears a close relationship to a realization requirement, at least when "realization" and "gross receipts" have their normal meanings. In the case of a normal realization event such as a sale of property, gross receipts are what the seller realizes on the sale. If the realization requirement in the regulations were based on the conventional understanding of realization, it might make sense to impose a gross receipts requirement in addition to a realization requirement.

However, in light of the substantial attenuation of the realization requirement in the regulations that results primarily from the rule that taxes on unrealized appreciation can satisfy this requirement, together with the similar attenuation in the gross

receipts requirement that results from the fact that taxes on fair market value satisfy the requirement (so that taxes on unrealized appreciation can satisfy the requirement), it is far from clear what purpose is served by the imposition of such an attenuated gross receipts requirement in addition to such an attenuated realization requirement.

None of the preambles to the various proposed, temporary, or final regulations provided any explanation of the reasons why the gross receipts requirement was imposed as a condition for creditability in addition to the realization requirement, in light of the extremely attenuated form taken by both requirements in the regulations. Thus, like the realization requirement, the gross receipts requirement is vulnerable to challenge on the basis of respondent's failure to explain, at the time the regulations were issued, why the gross receipts requirement was imposed.

Any residual purpose that might be served by these two requirements in the attenuated form they take in the regulations would be much better served by provisions that were targeted more clearly and more directly at whatever potential taxing regimes were intended to be excluded from creditability under these requirements in their attenuated form. Thus, for example, at a minimum, in light of the rule that a tax based on fair market value satisfies the gross receipts requirement, the clarity and transparency of the regulations would have been substantially increased if the gross receipts requirement had been renamed a fair market value requirement.

However, even though the gross receipts requirement as formulated in the regulations is vulnerable to challenge under the arbitrary and capricious standard, it is nevertheless clear that the windfall tax satisfies this requirement, because respondent has conceded that the windfall tax was based on fair market value, and the regulations provide that a tax based on fair market value satisfies the gross receipts requirement.

III. Net income requirement

A. When the net income requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement.

Finally, when the net income requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement. Under the net income requirement, the foreign tax base must permit the recovery of the reasonable costs and expenses attributable to the item that is being taxed. The U.K. statutory formula for determining the profit-making value of a company subject to the tax was based on the company's actual reported profits. That formula necessarily takes into account the costs incurred by the company in earning those profits, because those costs were taken into account in the determination of the profits used in that formula. Moreover, a tax on the unrealized appreciation in the value of a business necessarily takes into account the costs that were incurred by that business, and that

had an effect on that appreciation, over the period of time in which that unrealized appreciation occurred.

As in the case of the gross receipts requirement, it would be nonsensical for the regulations to provide that a tax on unrealized appreciation satisfies the realization requirement if such a tax would inevitably fail the net income requirement. The reason a tax on unrealized appreciation satisfies the net income requirement is that the subtraction of the initial value of the property from the property's appreciated value in calculating the tax base represents the cost recovery the net income requirement demands. Because the windfall tax base was equal to the excess of profit-making value over flotation value, this tax satisfies the net income requirement for the same reason any tax on unrealized appreciation satisfies the net income requirement. The subtraction of flotation value from profit-making value in the calculation of the windfall tax base represents the cost recovery the net income requirement demands.

CONCLUSION

When the realization requirement, the gross receipts requirement, and the net income requirement in respondent's regulations are applied to the U.K. statutory formula for the windfall tax, the tax satisfies these requirements. Accordingly, the windfall tax is creditable.

Respectfully submitted,

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AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

No. 12-43

In The
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

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QUESTION PRESENTED

Whether, contrary to decades of case law, courts should look only at the technical nomenclature used in a foreign tax statute and not consider the practical operation and economic substance of the foreign government's tax assessment when determining whether, under U.S. law, an American taxpayer who pays the foreign tax may claim the traditional statutory right against double taxation found in section 901 of the Internal Revenue Code.

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INTEREST OF *AMICI CURIAE*[1]

Southeastern Legal Foundation, Inc. ("SLF") is a nonprofit national constitutional public interest law firm and policy center that promotes the public interest in the proper construction and enforcement of the laws and Constitution of the United States in the courts of law and through public discourse. SLF advocates constitutional individual liberties, limited government, and the free enterprise system in its litigation cases and *amicus* participation in state and federal courts.

Many of the litigation matters and policy debates in which SLF has participated since its founding in 1976 have involved the vindication of private property rights. SLF has represented parties and submitted *amicus* briefs before this Court in numerous cases presenting governmental threats to the property rights of individuals and businesses, including through overreaching use of eminent domain powers and excessive and imbalanced regulation. SLF prides itself on defending ordinary citizens and small business owners in local communities throughout America who find their freedom and their property under

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[1] All parties have consented to the filing of this brief in letters on file with the Clerk of the Court. No counsel for a party has authored this brief in whole or in part, and no person other than *amici*, their members, and their counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.

challenge from arbitrary and unreasonable bureaucratic power.

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber represents 300,000 direct members and indirectly represents an underlying membership of more than three million businesses and professional organizations of every size, in every industry sector, and from every region of the country. The Chamber represents the interests of its members in matters before Congress, the Executive Branch, and the courts. The Chamber regularly files *amicus* briefs in cases that raise issues of vital concern to the Nation's business community.

The Cato Institute ("Cato") was established in 1977 as a nonpartisan public policy research foundation dedicated to the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the constitutional limits on government that are the foundation of freedom. Toward those ends, Cato publishes books and studies, conducts conferences and forums, and publishes the annual *Cato Supreme Court Review*. Cato participates from time to time as an *amicus* in important cases implicating fundamental liberties, structural protections for individual rights, and judicial checks on arbitrary government action.

The Goldwater Institute ("Goldwater") is a nonprofit educational foundation established in 1988.

Through litigation, research papers, editorials, policy briefings, and forums, Goldwater advances nonpartisan public policies founded upon the principles of limited government, economic freedom, and individual responsibility. Goldwater participates in court cases and frequently files *amicus* briefs through its Scharf-Norton Center for Constitutional Litigation.

Amici file this brief because the legal position taken below by the Commissioner of Internal Revenue raises basic issues of agency power that transcend the interests of any particular taxpayer or class of taxpayers. This case concerns the limits of the power of a federal agency to apply a statute originally focused on economic substance in a manner that utterly ignores the true nature of the underlying transaction. *Amici* urge the Court to rein in the Commissioner's discretion to act against the property interests of individuals and businesses through an overly formalistic reading of the law that only serves the convenience and institutional self-interests of the tax collector.

SUMMARY OF ARGUMENT

The Court should reverse the judgment of the court of appeals and reject the Commissioner's hyperformalistic application of the credit for foreign "excess profits taxes" allowed in section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1).

The Commissioner's opposition to the allowance of a tax credit for payment of the British Windfall Tax contravenes the traditional understanding of section 901 long held by the courts, including this Court, and is inconsistent with the Commissioner's own previous focus on substance and economic reality in judging the availability of the foreign tax credit under the relevant Treasury regulation. The application of section 901 espoused by the Commissioner and approved by the Third Circuit takes a venerable principle of the tax code that has long been held to require an examination of the true underlying substance and operation of a foreign tax and improperly converts it into a mechanical review that refuses to look beyond the superficial language of the foreign law.

It is revealing that the Commissioner has invoked this myopic approach to section 901 to deny the taxpayer a foreign tax credit and coincidentally to advance the revenue-raising objectives of the Internal Revenue Service. Not surprisingly, in cases where the IRS believes the literal terms of a foreign tax provision tend to disguise its true character, the Commissioner has not hesitated to present extensive evidence of the tax's underlying purpose and economic substance as a basis to deny the taxpayer a credit under section 901. And in numerous cases before this Court, the federal government has consistently emphasized a substance-over-form approach to questions of taxation.

The self-serving nature of the Commissioner's current position is a ringing alarm that betrays the

arbitrariness of the government's shifting approach to section 901 and the danger that it poses for taxpayers who rely upon a consistent and predictable application of the tax code in structuring their transactions. Fundamentally, section 901 is a statutory grant of protection from double taxation, and taxpayers have a right to be free from government action that manipulates the code to take away that protection in favor of maximizing tax collections.

ARGUMENT

THE COMMISSIONER'S RIGIDLY FORMALISTIC POSITION SHOULD BE REJECTED AS AN ADMINISTRATIVE OVERREACH THAT BREAKS FAITH WITH THE HISTORICAL UNDERSTANDING OF SECTION 901.

A. The Hyper-Formalism Advocated by the Commissioner Departs Starkly from the Traditional Interpretation of Section 901.

The Commissioner's argument for denying taxpayers a section 901 credit for payment of the United Kingdom's Windfall Tax cannot be squared with the established substantive approach to the foreign tax credit originally intended by Congress and long approved by the courts, including this Court.

1. Historically, the Availability of the Section 901 Credit Has Turned on the Economic Substance of the Foreign Tax Assessment.

First enacted in 1918 and substantially unchanged in 94 years, section 901 grants U.S. citizens and businesses a credit for "the amount of any income, war profits, and excess profits taxes paid" to a foreign country. 26 U.S.C. § 901(b)(1). The credit allowance was designed "to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

Until the decision below, the courts interpreting section 901 have consistently held that "[t]he label and form of the foreign tax is not determinative" of the availability of the tax credit. *Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982). Whether or not the foreign levy "is labeled a gross income or a net income tax" or uses some other "form" or "name," "[t]he important thing is whether the other country is attempting to reach *some net gain*," *Bank of Am. Nat. Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972) (emphasis added).

This Court's longstanding interpretation of section 901 reflects the same understanding. In *Biddle v. Comm'r*, 302 U.S. 573 (1938), the Court held that a taxpayer who was a shareholder in a British corporation was not entitled to a credit for a British income tax assessed on the taxpayer's proportionate share of the taxes paid by the corporation on its own profits.

Id. at 575, 580-82. These amounts, although denominated "income" in the U.K., were not actually received by the shareholder as dividends and would not be considered taxable income under the U.S. tax code, and thus the taxpayer would not face double taxation in the absence of a credit. *See id.* at 581-82. Importantly, the Court reasoned that the availability of a credit under section 901 is not determined "by reference to foreign characterizations and classifications of tax legislation." *Id.* at 579.

In accordance with this emphasis on substance, courts addressing the availability of the tax credit have not hesitated to look beyond the terminology of the foreign statute to examine the assessment's purpose and substantive effect. *See Inland Steel*, 677 F.2d at 82 (exploring "History and Purpose" of foreign tax); *see also Texasgulf, Inc. v. Comm'r*, 172 F.3d 209, 211-14 (2d Cir. 1999) ("Essential to the resolution of this appeal is an understanding of the nature and operation of the [foreign tax] during the relevant taxable years.") (discussing trial evidence, including expert testimony, on "the industry-wide operation" of the tax).[2]

Treasury Regulation 1.901-2, promulgated by the IRS in 1983 to implement section 901, reflects the

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[2] The rules of procedure for both the Tax Court and the district courts make it clear that in determining a foreign law, the court "may consider any relevant material or source, including testimony, whether or not submitted by a party or otherwise admissible." Tax Ct. R. 146; *see* Fed. R. Civ. P. 44.1 (same).

case law that grew up under the statute. Regulation 1.901-2 groups together the three types of taxes listed in section 901 ("income, war profits, and excess profits taxes") into a single concept of "income tax," which the rule then defines as a foreign tax "[t]he predominant character of" which "is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii); Pet. App. 109. The regulation further specifies that the "predominant character" test is satisfied only if the foreign tax "is likely to reach net gain in the normal circumstances," and only if, "judged on the basis of its predominant character," the tax meets three technical requirements: (1) It is imposed upon or after the "realization" of income; (2) it is imposed on the basis of "gross receipts," and (3) the base of the tax constitutes "net income"—"gross receipts" less "significant costs and expenses." Treas. Reg. 1.901-2(b)(2), (3), (4); Pet. App. 114, 120, 122.

Until the present case, the Commissioner has applied Regulation 1.901-2 consistently with the substance-over-form reasoning traditionally followed in the courts.

2. The Approach Advocated by the Commissioner and Adopted by the Third Circuit Improperly Ignores the Substance of the British Windfall Tax.

Based on the history recited above, one would think there is little room for doubt that the British Windfall Tax is an "excess profits tax" within the

meaning of section 901. The U.K. law was enacted in 1997 by the British Labour Government for the express purpose of taxing what Parliament figured were "excess" or "windfall" profits earned by businesses that had been privatized by the Conservative Government in the 1980s. For U.S. owners of the affected businesses, the U.K. assessment raises the specter of double taxation. *See* Pet. Br. 5-11.

The Windfall Tax satisfies the requirements of Treasury Regulation 1.901-2's long-established "predominant character" test because the tax assessment is based on, and increases in proportion to, a subset of the financial profits realized by the affected businesses. The British statute levies a 23-percent tax rate against the difference between the historical purchase price paid for the privatized businesses in question (called the "flotation value") and a "profit-making value," which is calculated on the basis of the profits (*i.e.*, gross receipts less operating costs—in other words, net income) *actually earned* by the businesses during the specified four-year period. The tax works out to about 52 percent of actual profits earned above a prescribed rate of return during the relevant period, and therefore the assessment could never exceed any appropriate measure of income.

Applying this substantive analysis, the Fifth Circuit had no problem concluding that a tax credit is available under section 901 for payment of the U.K. Windfall Tax. *See Entergy Corp. v. Comm'r*, 683 F.3d 233, 238 (5th Cir. 2012). Writing for the Fifth Circuit, Chief Judge Jones concluded that the Commissioner's

invitation to "rely exclusively, or even chiefly, on the text of the Windfall Tax" was incompatible with the traditional substance-based approach to the foreign tax credit. *Id.* at 236. As she stated: "The tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor. That Parliament termed this aggregated but entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax, that is, its predominant character." *Id.* at 236-37.[3] The essence of the Fifth Circuit's holding is that the British Windfall Tax is creditable because (1) it reaches realized income, and (2) gross revenue was an inherent part of the calculation.

In its decision below, however, the Third Circuit accepted the Commissioner's novel argument that, to the contrary, the court must confine itself to the terminology used in the Windfall Tax statute and must not consider the substantive nature and effect of the tax in judging whether a credit is proper. The court determined that the British tax could not be treated as an assessment against net income for purposes of Treasury Regulation 1.901-2 because,

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[3] The Fifth Circuit explained that the "gross receipts" requirement in Treasury Regulation 1.901-2 is designed "to prevent foreign nations from 'soaking up' American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount *greater than the business's actual gross receipts*." 683 F.3d at 237 (emphasis added) (citing Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates & Gifts ¶ 72.1 (2011)).

according to the U.K. statute's taxing formula, the tax is levied against an amount determined using an imputed number labeled "profit-making value," rather than against a simpler measure of net income that is expressly denominated "net income" or "gross receipts." *See* Pet. App. 8-15. The Third Circuit ignored the substantive components of the formula and erroneously concluded that the tax was not imposed on the basis of actual gross revenue—an integral part of the calculation—and was therefore not creditable.

Under the Commissioner's approach, adopted by the Third Circuit, a taxpayer claiming the section 901 credit may not inquire beyond the language of the foreign enactment, and the Tax Court may not consider evidence of the foreign tax law's practical operation and substantive effect, *see id.* at 8, even though such evidence has commonly been presented in prior cases under section 901, *see, e.g.*, *Texasgulf, Inc.*, 172 F.3d at 211-14. This position severs the last link to any meaningful examination of the foreign tax's "history and actual effect," *Entergy Corp.*, 683 F.3d at 237. It abandons the substantive "predominant character" test codified in the Treasury Regulation and supplants it with a rote, mechanical application of the rule's sub-factors to the literal language of the foreign statute.[4]

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[4] *See* George Orwell, *Nineteen Eighty-Four* 255 (New American Library ed. 1981) (Appendix: "The Principles of Newspeak") ("When Oldspeak had been once and for all superseded, the last link with the past would have been severed.").

This hyper-formalistic application of section 901 threatens taxpayers with the arbitrary denial of their traditional statutory right against "the evil of double taxation," *Burnet*, 285 U.S. at 7. Unless rejected by this Court, the Commissioner's abrupt break from the historical understanding of section 901 will subvert the stability and predictability of financial transactions for U.S. individuals and companies with business interests overseas.

B. The Commissioner's Position Is Opportunistic and Inconsistent with the Government's Usual Emphasis on Substance Over Form.

The degree to which the Commissioner's current position is unfaithful to the traditional understanding of section 901 is underscored by its self-serving nature. The approach advocated by the Commissioner bears the hallmarks of a litigating position that has been adopted out of convenience and selectively applied by the IRS only where it works against the taxpayer and increases the returns to the tax collector.

Over the decades, the shoe was on the other foot, and it was the Commissioner who urged a substantive examination into the nature and effect of the foreign tax to show that the section 901 credit should be disallowed. *See, e.g.*, *Biddle v. Comm'r*, 302 U.S. at 579 (noting that the Board of Tax Appeals made findings in the Commissioner's favor "supported . . .

by much expert testimony," and mandating, at the urging of the Commissioner, "an examination of the manner in which the British tax is laid and collected . . . and whether it is the substantial equivalent of payment of the [income] tax as those terms are used in our own statute").

The Commissioner's past record of preferring a substance-based approach to the foreign tax credit is fully in line with the government's traditional position before this Court that substance must trump form in the interpretation and application of all provisions of the Internal Revenue Code. *See, e.g.*, Brief for United States 10, *United States v. Centennial Savings Bank FSB*, No. 89-1926 (U.S. filed Nov. 15, 1990) (noting "fundamental principle of federal taxation that the substance rather than the form of a transaction determines its tax consequences"); Brief for United States 22, 27-28, *Frank Lyon Co. v. United States*, No. 76-624 (U.S. filed July 28, 1977) (arguing that Commissioner correctly disregarded form in favor of economic substance); Brief for United States 34, *United States v. Consumer Life Ins. Co.*, No. 75-1221 (U.S. filed Aug. 4, 1976) (urging "the familiar axiom that economic substance rather than form is controlling for purposes of federal taxation" and approving "the substance-over-form doctrine" applied by this Court "in a number of landmark decisions that have been a major influence in shaping the development of our federal tax jurisprudence"); Brief for United States 13-14, *United States v. Byrum*, No. 71-308 (U.S. filed Dec. 1971) (noting that "this Court has

consistently held that substance and reality, rather than form, are to govern in the application of" various provisions of the Internal Revenue Code).

The Solicitor General has long taken the same approach when the issue turns on the nature or operation of a state tax (for example, in cases addressing the immunity of the federal government or an Indian tribe from state taxation). *See, e.g.*, Brief for United States as *Amicus Curiae* Supporting Respondent 13, *Wagnon v. Prairie Band Potawatomi Nation*, No. 04-631 (U.S. filed July 14, 2005) (arguing that in determining whether the legal incidence of a state tax falls on an Indian tribe, the Court should look beyond the form and labels used in the tax to its substantive effect); Brief for United States 13, *City of Detroit v. Murray Corp. of Am.*, No. 18 (U.S. filed Oct. 12, 1957) ("Neither form nor nomenclature of a tax is controlling over substance."); Brief for United States 19-20, *United States v. Evans*, No. 378 (U.S. filed Feb. 24, 1953) (arguing that in considering the relevant character of a state gasoline tax, the Court must look "to substance rather than form, to practical operation and effect rather than nomenclature, to realities and not to labels"; "The name by which the tax is described in the statute is, of course, immaterial. Its character must be determined by its incidents. . . .") (internal quotation marks and citations omitted); Brief for United States 60, *Alabama v. King & Boozer*, No. 602 (U.S. filed Oct. 21, 1941) (arguing that the "validity of taxes challenged as invading the immunity of the Government should be decided . . . in terms

of the legal incidence of the tax," which is determined by looking "to substance and reality, not to form").[5]

The government's awkward turnabout when it comes to the British Windfall Tax smacks of opportunism—a short-sighted maneuver calculated to boost tax collections, but at the expense of the long-term benefits of a consistent and predictable tax policy. The contrast between the government's frequent preference for economic substance in past cases where it served the government's interests and the Commissioner's current rush to elevate superficial terminology over economic reality betrays an indefensible arbitrariness. Ultimately, federal tax authorities should not be able to use a foreign tax's form or label to mask the tax's true substantive character. Otherwise, American taxpayers who have staked their foreign investments on the predictability and economic soundness of the U.S. tax code become the victims of cynical and arbitrary government action.

In sum, the position ratified by the court of appeals below represents a dangerous and self-serving exercise of administrative power. This Court should reaffirm the substantive protection originally granted

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[5] *See also Fairbank v. United States*, 181 U.S. 283, 305 (1901) ("we must always regard things rather than names"), *quoted in* Reply Brief for United States 11, *United States v. United States Shoe Corp.*, No. 97-372 (U.S. filed Feb. 18, 1998) (addressing analysis for distinguishing a fee from a tax).

by Congress in section 901 by rejecting the arbitrary position now pushed by the Commissioner.

CONCLUSION

For the foregoing reasons, *amici curiae* urge the Court to reverse the judgment of the court of appeals.

Respectfully submitted,

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December 20, 2012